AN ANALYSIS OF MALAYSIA'S CORPORATE INCOME TAX EXPENDITURES AND NEGATIVE INCOME TAX EXPENDITURES USING ACCOUNTING STANDARDS AS THE BENCHMARK TAX BASE

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ABSTRACT

Tax expenditures are government indirect spending, hidden in the tax system, often used to support government's social and economic objectives. Instead of directly allocating money for a particular objective, the government forgoes tax revenues from those who undertake activities that could achieve the objective. Therefore, tax expenditures should be analysed as government spending programs. Tax expenditure reporting and analysis has been a regular practice among many countries in the world, especially in developed countries, to ensure efficient and effective allocation of government resources and enhance government's transparency. Unfortunately, despite having lavish tax incentives, the Malaysian government has not produced a tax expenditure report. As a result, tax expenditures are mistakenly analysed as aspects of the tax collection system rather than as part of spending programs.

This thesis sets a foundation for tax expenditure reporting and analysis in Malaysia by identifying and analysing tax expenditures of Malaysia's corporate income tax arising from all sources of tax law – tax legislation, case law and administrative practices. In addition, this thesis also identifies and analyses negative tax expenditures that provide disincentives to government-disfavoured activities. The main objective of this thesis is to determine whether particular corporate income tax expenditures or corporate negative income tax expenditures should be removed, maintained or modified using the conventional tax expenditure analysis. Prior to identifying tax expenditures, elements of a benchmark tax structure are developed. This thesis contributes to new knowledge by proposing Malaysian accounting standards as the benchmark tax base to identify corporate tax expenditures. Any tax rules that deviate from the benchmark tax structure are analysed as tax expenditures (if they lower tax payable) or negative tax expenditures (if they increase tax payable).

Conventional tax expenditure analysis commences with an assertion of (or speculation about) the apparent objective of each of the tax expenditures and negative tax expenditures being assessed, asking first whether there are justifiable reasons for the government to intervene in the market by offering subsidies or imposing penalties based

on taxpayers' behaviour. If government intervention can be justified, the next step is to propose the optimal vehicle to achieve the objective.

The findings of this thesis reinforce doubts held by some about the effectiveness of tax expenditures as tools to promote government objectives. A number of the tax expenditures identified appear to be redundant, providing government support for companies to undertake actions that they would likely do even without the tax expenditures. Most tax expenditures in Malaysia are not accurately targeted; they only benefit profitable companies and thus miss many enterprises most in need of assistance. There are also tax expenditures that have lost their relevancy, including a few that were inherited from the British tax system. They have been forgotten or accepted as part of the normative tax system, and are left in the legislation with no revision.

Most negative tax expenditures that are explicitly legislated have plausible reasons to stay in the tax system. However, implicit negative tax expenditures that stem from strict judicial interpretations have led to the denial of deductions for some normal business expenses. This is unfair to businesses.

Overall, this thesis demonstrates the importance of tax expenditure reporting and analysis, particularly in Malaysia, to help the government in managing its resources and formulating better policies.

DECLARATION

I hereby declare that this thesis contains no material which has been accepted for the award of any other degree or diploma at any university or equivalent institution and that, to the best of my knowledge and belief, this thesis contains no material previously published or written by another person, except where due reference is made in the text of the thesis.

This thesis includes one original paper published in a peer reviewed journal. The core theme of the thesis is tax expenditure analysis. The ideas, development and writing up of all the papers in the thesis were the principal responsibility of myself, the candidate, working within the Department of Business Law and Taxation under the supervision of Professor Rick Krever (the principal supervisor) and Professor Jeyapalan Kasipillai (the associate supervisor).

In the case of Chapter Six, my contribution to the work involved the following:

> Salwa Hana Yussof, 'Tax Disincentives Arising from Judicial Decisions on the Deductibility of Expenses' (2011) 17(4) *Asia-Pacific Tax Bulletin* 285.

I have renumbered sections of published paper in order to generate a consistent presentation within the thesis.

Signed: ……

Date: ……

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LIST OF ACCOUNTING STANDARDS

LIST OF ABBREVIATIONS

ACCA	Association of Chartered Certified Accountants
CCCTB	Common Consolidated Corporate Tax Base
CER	Certified Emission Reduction
CGT	Capital gains tax
CTIM	Chartered Tax Institute of Malaysia
DGIR	Director General of Inland Revenue
EPF	Employees Provident Fund
EU	European Union
FRF	Financial Reporting Foundation
GBI	Green Building Index
GDP	Gross Domestic Product
GPS	Global Positioning System
HRDF	Human Resources Development Fund
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IC	Interpretation Committee
ICAEW	Institute of Chartered Accountants of England and Wales
ICT	Information and communication technology
IDR	Iskandar Development Region
IFRS	International Financial Reporting Standard
IM	Iskandar Malaysia
IMF	International Monetary Fund
INCEIF	International Centre of Education in Islamic Finance
IRBM	Inland Revenue Board of Malaysia
ISO	International Standard Organisation
ITA 1967	Income Tax Act 1967
JCT	Joint Committee on Taxation
KPHDN	*Ketua Pengarah Hasil Dalam Negeri*
Labuan FSA	Labuan Financial Services Authority
Labuan IBFC	Labuan International Business and Financial Centre
LBATA 1990	Labuan Business Activity Tax Act 1990
MAS	Malaysian Accounting Standard
MASB	Malaysian Accounting Standards Board
MFRS	Malaysia Financial Reporting Standard
MIA	Malaysian Institute of Accountants
MICPA	Malaysian Institute of Certified Public Accountants
MIDA	Malaysian Industrial Development Authority
MSC Malaysia	Multimedia Super Corridor Malaysia

NCER	North Corridor Economic Region
NGV	Natural Gas for Vehicles
OECD	Organisation for Economic Co-operation and Development
OMB	Office of Management and Budget
Petronas	Petroliam Nasional Berhad
PIA 1986	Promotion of Investments Act 1986
PITA 1967	Petroleum (Income Tax) Act 1967
QCE	Qualifying capital expenditure
R&D	Research and development
RPGT	Real property gains tax
SCIT	Special Commissioners of Income Tax
S-H-S	Schanz-Haig-Simons
SME	Small and medium enterprise

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE RESEARCH

In many countries, tax systems include provisions that have nothing to do with the basic functions of raising revenue and redistributing income in a neutral manner. These provisions, widely referred to as tax expenditures, provide implicit subsidies to encourage certain behaviours or to provide tax relief to those deemed entitled to it.[1] While tax expenditures are formulated to achieve various social and economic objectives, direct spending can also be used to achieve the same objectives.[2] Somewhat surprisingly, until the late 1960s there existed no conceptual structure for the analysis of these measures, which were simply accepted as part of the complexity of income tax law.

The concept of tax expenditures was developed in 1967 by the Assistant Secretary of the United States Treasury for Tax Policy, Professor Stanley S Surrey, in a presentation entitled 'The United States Income Tax System – The Need for a Full Accounting' delivered to Money Marketeers in New York City on 15 November of that year.[3] Surrey posited that tax expenditures should be subject to the same analysis as direct government expenditure. The development of tax expenditure analysis in the late 1960s and its refinement in the 1970s provides a theoretical basis for analysing these departures from the neutral tax benchmark. Therefore tax expenditure analysis has

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[1] Neil Brooks, 'The Under-Appreciated Implications of the Tax Expenditure Concept' in Chris Evans and Richard Krever (eds), *Australian Business Tax Reform in Retrospect and Prospect* (Thomson, Sydney, 2009) 233, 233.

[2] Stanley S Surrey, 'Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance' (1970) 84(2) *Harvard Law Review* 352, 354.

[3] Stanley S Surrey and William F Hellmuth, 'The Tax Expenditure Budget: Response to Professor Bittker' (1969) 22(4) *National Tax Journal* 528, 528; Stanley S Surrey, *Pathways to Tax Reform: The Concept of Tax Expenditures* (Harvard University Press, Cambridge, MA, 1973) 3.

become an important budgetary control to assist government in deciding upon the best approach to achieve these objectives.

Tax expenditures are indirect government spending. Instead of collection of revenue by the government through taxation and use of that revenue to deliver assistance through grants or other direct financial assistance, tax expenditures provide a reduction in tax payable. Literally, it appears as though both methods provide the same outcome. Either a company pays tax amounting to AUD 1,000 and receives back AUD 200 through grants, or it pays a reduced amount of tax of AUD 800, after allowing for government assistance with a tax equivalent value of AUD 200 delivered through tax expenditures. Unfortunately, in reality the fact is not so straightforward. Due to the nature of tax expenditures, the exact amount spent indirectly through such expenditures is hard to determine. Without a comprehensive tax expenditure report, the cost of tax expenditures is hidden from the public. The situation is worse if the legislature and the policy-makers themselves do not know how much the tax expenditures cost the government.

Currently, along with the US, many other developed countries, such as Australia, Canada, France, the UK, Japan and Korea, publish a tax expenditure report of some kind that shows the amount of revenue forgone as a result of tax expenditures (that is, the amount of tax that would be payable if the tax incentives were removed). Some developing countries, including India, South Africa, Chile and Brazil,[4] have adopted a similar practice. Many others are moving towards it. The publication of a tax expenditure report promotes government transparency by providing the public with a more meaningful assessment of the tax system.

As a developing country, Malaysia offers lavish tax incentives to attract investors. Unfortunately, these tax incentives are not viewed as tax expenditures, and have escaped the analysis that should have been placed on direct spending. Occasionally, the government has disclosed the expected revenue forgone when a new tax expenditure is

[4] Mark Burton and Miranda Stewart, 'Promoting Budget Transparency Through Tax Expenditure Management: A Report on Country Experience for Civil Society Advocates' (Legal Studies Research Paper No 544, Melbourne Law School, University of Melbourne, 14 June 2011) 35.

introduced.[5] However there is no continuous annual disclosure and the revelation of the expected revenue forgone is not available for newly-introduced tax incentives in all cases.

During a Malaysian tax conference held in 2005, Professor Emeritus Frank Flatters of Queen's University, Canada proposed that tax expenditures be included and quantified in the annual government budget.[6] He emphasised the importance of information about the cost of tax incentives, and how the absence of that information could impose substantial financial costs on the government, not only through revenue forgone but also through an increase in administrative and compliance costs.[7] Unfortunately, after more than six years, the government of Malaysia still has not produced any kind of tax expenditure report.[8]

One recent development which can be noted is the launch by the government in 2010 of the Economic Transformation Programme as part of the government's initiative for Malaysia to be a high-income nation by 2020.[9] One of the program's components, the Strategic Reforms Initiatives, contains six recommendations by the National Economic Advisory Council, one of which relates to Public Finance Reform. Among the initiatives under Public Finance Reform is the Rationalisation of Corporate Tax Incentives, which involves review and reconsideration of existing tax incentives.[10] This is a good effort from the government; however, it is still far from the implementation of tax expenditure reporting. Tax expenditures need to be reviewed and analysed at regular intervals. Besides, not all tax expenditures are covered by the initiatives, especially those that are accepted as being part of the normal tax structure, such as the initial capital allowance.

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5 For example, see *Malaysian Budget Speech 2003*, para 68.

6 Frank Flatters, 'International Perspectives on Tax Incentives in Malaysia' (Presentation delivered at the Malaysian Institute of Taxation National Tax Conference, *An Effective Tax Regime, A Joint Responsibility*, Putrajaya, Malaysia 9-10 August 2005) 9.

7 Flatters, above n 6, 6-7.

8 Burton and Stewart, above n 4, 73. This study searched for tax expenditure reporting in 36 countries including Malaysia. The study did not find anything with respect to tax expenditure reporting in Malaysia.

9 Economic Transformation Programme, *Overview of ETP* <http://etp.pemandu.gov.my/Overview-@-Overview_of_ETP.aspx>.

10 Economic Transformation Programme, *Overview of Public Finance Reform* <http://etp.pemandu.gov.my/Public_Finance_Reform-@-Overview.aspx>.

1.2 DEFINITION OF TERMS

The following terms are fundamental to this thesis and are used frequently:

i. Corporate Income Tax Expenditures

According to Surrey, tax expenditures are special tax provisions that depart from the normal tax structure and are designed to favour a particular industry, activity, or class of persons.[11] The definition of tax expenditures varies depending on the chosen normal tax structure, that is, the tax benchmark. Since this thesis uses accounting standards as the neutral tax benchmark, the term 'corporate income tax expenditures' in this thesis refers to:

> Any corporate income tax treatments that deviate from accounting practices and other specified benchmark tax structure, which cause a reduction in tax revenue collected by government.

Thus, the concept may include various tax incentives such as allowances, concessions, deductions, exemptions, rebates and different tax rates. Normally tax expenditures are granted to achieve certain government objectives, which could alternatively be achieved by way of direct spending. Tax treatments that are labelled as tax incentives by the government but which are consistent with accounting practices and other specified benchmark tax structure, for example incentives given by way of deductions for pre-operational expenses, are excluded from this definition.

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[11] Stanley S Surrey and Paul R McDaniel, *Tax Expenditures* (Harvard University Press, Cambridge, MA, 1985) 3; Stanley S Surrey, 'Tax Subsidies as a Device for Implementing Government Policy' (1972) 3(4) *Tax Adviser* 196, 197; Surrey, *Pathways to Tax Reform*, above n 3, 6; Stanley S Surrey and Paul R McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974' (1976) 17(5) *Boston College Industrial and Commercial Law Review* 679, 680; Stanley S Surrey, 'At Home: Tax Expenditures' (1976) 18(6) *Challenge* 53, 53; Stanley S Surrey and Paul R McDaniel, 'Tax Expenditure Concept: Current Developments and Emerging Issues' (1979) 20(2) *Boston College Law Review* 225, 228; Lotfi Maktouf and Stanley S Surrey, 'Tax Expenditure Analysis and Tax and Budgetary Reform in Less Developed Countries' (1983) 15 *Law & Policy in International Business* 739, 743.

ii. Corporate Negative Income Tax Expenditures

In this thesis, the term 'corporate negative income tax expenditures' refers to:

> Any corporate income tax treatments that deviate from accounting practices and other specified benchmark tax base that lead to an increase in tax revenue collected by government.

Negative tax expenditures may be used to penalise certain groups or activities, or as a surrogate tax when it is impractical to tax the recipients of benefits. In other cases they may arise because of the application of judicial doctrines or interpretations to the law. An example of the former is the non-deductibility of expenses on fines and penalties. An example of the latter is the non-deductibility of depreciation incurred on certain depreciable assets.

iii. Direct Spending

As the name implies, in tax expenditure analysis, a tax expenditure is considered a type of government expenditure through the tax law as a substitute to direct spending. In other words, to achieve a particular goal, the government can choose either to use direct spending or tax expenditures. While direct spending involves disbursement of cash, tax expenditures involve a reduction of tax revenue. The term 'direct spending' can be defined as:

> Direct government assistance which is tabled in the yearly budget and approved by the Parliament to fund a country's administration and development activities.

iv. Tax Expenditure Analysis

While direct spending programs receive detailed scrutiny and their performance is assessed regularly, tax expenditures often escape the same review. A tax expenditure must be further analysed to decide whether it is the best method that can be used to

achieve the government's intended objective and should be maintained as a tax expenditure, or whether there is a more effective method of delivering assistance, either by way of direct spending or a better design of tax expenditure. Thus, the term 'tax expenditure analysis' refers to:

> A detailed scrutiny on tax expenditures which includes a review of their objectives, a cost-benefit analysis as compared to direct spending and other tax expenditure design, and a suggestion whether they should be removed, maintained or modified.

v. Tax Expenditure Report

Tax expenditures are hidden government spending. To enhance government transparency, relevant information about tax expenditures must be disclosed to the public. The availability of a tax expenditure report should provide information to enable greater scrutiny of tax expenditures. Therefore, the term 'tax expenditure report' is defined as:

> A report on tax expenditures that is produced at a regular interval by the Ministry of Finance or other relevant government agencies, and is made available to the public in the same way as the government's yearly budget.

vi. Benchmark Tax Base

According to Surrey, a tax system consists of two parts – the structural provisions and the special preference provisions.[12] The structural provisions are the benchmark tax structure, while the special preference provisions are the tax expenditures. One important element of the benchmark tax structure is the tax base, which helps to define

[12] Surrey, *Pathways to Tax Reform*, above n 3, 6; Surrey and McDaniel, *Tax Expenditures*, above n 11, 3; Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 680; Surrey, 'Federal Income Tax Reform', above n 2, 354; Surrey, 'Tax Subsidies as a Device for Implementing Government Policy', above n 11, 197; Surrey, 'At Home: Tax Expenditures', above n 11, 53; Surrey and McDaniel, 'Tax Expenditure Concept: Current Developments and Emerging Issues', above n 11, 227-228; Maktouf and Surrey, above n 11, 743; Stanley S Surrey, 'Tax Expenditure Analysis: The Concept and Its Uses' (Summer 1979) *Canadian Taxation* 3, 4.

what should be included in the taxable income. The term 'benchmark tax base' refers to:

> Tax rules that are considered necessary to ensure tax is imposed based on the concept of fairness and ability-to-pay.

1.3 STATEMENT OF THE PROBLEM

There are two sides of a government budget – the revenue side, and the spending side. Each side requires different types of analysis. The revenue side shows the sources of funds, usually to a large extent tax collection. Therefore, analysis should focus on the sources of the revenue and how to improve revenue collection. The spending side shows where the government spends the revenue collected, and analysis is important to ensure resources are spent wisely. As a substitute to direct spending, tax expenditures should be analysed on the spending side. Failure to understand the concept of tax expenditures would lead to tax expenditures being analysed on the revenue side; hence producing a misleading analysis.

Unfortunately, the concept of tax expenditures has not been understood by the Malaysian government and the general public. While the term 'tax incentives' is very common, the term 'tax expenditures' is still alien to many Malaysians.[13] As a result, tax expenditures escape the detailed scrutiny put on direct spending. There is no ongoing rigorous analysis of whether these incentives should be made available and whether this is the optimal way of delivering assistance.

This thesis aims to identify Malaysia's corporate tax expenditures and analyse them as a spending function, to determine whether they are the optimal tax policy for the government.

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[13] Kang Beng Hoe, 'Tax Policy and the Social Agenda', *The Star* (online), 20 Jan 2009 <http://biz.thestar.com.my/news/story.asp?file=/2009/1/20/business/3062514&sec=business>.

1.4 OBJECTIVES OF THE RESEARCH

The main objective of this thesis is to determine whether particular corporate income tax expenditures or corporate negative income tax expenditures should be removed, maintained or modified using the conventional tax expenditure analysis. Since Malaysia has not produced any official or unofficial report on tax expenditures, this thesis must first identify the corporate income tax expenditures and corporate negative income tax expenditures in Malaysia for this purpose. The objective of each of the tax expenditures and intention of each of the negative tax expenditures must also be determined to assist in the tax expenditure analysis. In order to identify the tax expenditures, this thesis must propose the elements of a benchmark tax structure for Malaysia's corporate income tax. Based on the benchmark, this thesis will also identify the tax treatments that are regarded as incentives by the government but are not tax expenditures, and tax treatments that are regarded as penalties or restrictions by the government but are not negative tax expenditures.

Therefore the main and subsidiary objectives of this thesis are as follows:

Main Objective 1

To propose the elements of a benchmark tax structure for corporate income tax in Malaysia, using Malaysia Financial Reporting Standards (MFRSs) as the income tax base.

Main Objective 2

To determine whether particular corporate income tax expenditures should be removed, maintained or modified, using the conventional tax expenditure analysis.

- **Sub Objective 2A**

  To identify Malaysia's corporate income tax expenditures based on corporate tax treatments that deviate from the proposed benchmark.

- **Sub Objective 2B**
  To determine the government's objective when they proposed each corporate income tax expenditure.

- **Sub Objective 2C**
  To identify corporate income tax incentives that do not deviate from the proposed benchmark.

Main Objective 3

To determine whether particular corporate negative income tax expenditures should be removed, maintained or modified, using the conventional tax expenditure analysis.

- **Sub Objective 3A**
  To identify Malaysia's corporate negative income tax expenditures based on corporate tax treatments that deviate from the proposed benchmark.

- **Sub Objective 3B**
  To determine the government's intention when they imposed each corporate negative income tax expenditure.

- **Sub Objective 3C**
  To identify corporate income tax penalties or restrictions that do not deviate from the proposed benchmark.

1.5 RESEARCH QUESTIONS

To achieve Main Objective 1, the research question is:

i. What are the elements of a benchmark tax structure for Malaysia's corporate income tax?

To achieve Main Objective 2, the research questions are:

i. Is the purpose of introducing a particular corporate income tax expenditure to support a government policy objective?
ii. If the corporate income tax expenditure does support a government policy objective, is a tax expenditure the best way to achieve the objective?
iii. If a tax expenditure is the best way to achieve the objective, what is the best tax expenditure design that should be used?

To achieve Sub Objective 2A, the research question is:

i. What are the corporate tax treatments that deviate from the proposed benchmark and cause a reduction in the government's tax revenue?

To achieve Sub Objective 2B, the research question is:

i. What is the objective that the government is trying to achieve when they propose a particular corporate income tax expenditure?

To achieve Sub Objective 2C, the research question is:

i. What are the corporate tax treatments that cause a reduction in government's tax revenue and are regarded as incentives but conform to the proposed benchmark?

To achieve Main Objective 3, the research questions are:

i. Is the purpose of introducing a particular corporate negative income tax expenditure to support a government policy objective?
ii. If the corporate negative income tax expenditure does support a government policy objective, is a negative tax expenditure the best way to achieve the objective?
iii. If a negative tax expenditure is the best way to achieve the objective, what is the best negative tax expenditure design that should be used?

To achieve Sub Objective 3A, the research question is:

i. What are the corporate tax treatments that deviate from the proposed benchmark and cause an increase in the government's tax revenue?

To achieve Sub Objective 3B, the research question is:

i. What is the government's intention when they impose a particular corporate negative income tax expenditure?

To achieve Sub Objective 3C, the research question is:

i. What are the corporate tax treatments that cause an increase in the government's tax revenue and are regarded as penalties or restrictions but conform to the proposed benchmark?

1.6 RESEARCH METHODOLOGY

This thesis uses conventional qualitative doctrinal analysis techniques to identify and define an underlying concept, the tax expenditure, to consider features of the Malaysian tax system with the object of classifying them as elements of the benchmark tax system or as income tax expenditures (and negative income tax expenditures) operating within the tax system, and then to evaluate critically those features found to be tax expenditures and negative tax expenditures. This approach imports accepted conclusions from previous literature and applies these to develop an alternative approach to establish an appropriate benchmark for identifying tax expenditures. Qualitative tax expenditure analysis techniques imported from international experience are then applied to the Malaysian tax system for identification and evaluation of tax expenditures.

Data for this thesis was gathered from various documents, including legislative materials, case law, tax circulars, accounting standards, newspapers, government documents, articles, reports and internet materials, using the document analysis method as the systematic procedure for evaluating documents.[14] Information from these documents is used to produce the list of tax expenditures and negative tax expenditures, to find their objectives, to track for changes and developments in a particular issue, and to learn the approach taken by other countries on a similar issue.

[14] Glenn A. Bowen, 'Document Analysis as a Qualitative Research Method' (2009) 9(2) *Qualitative Research Journal* 27, 27; 29-31.

The list of corporate income tax expenditures and corporate negative income tax expenditures in Malaysia must be compiled from multiple sources. These tax expenditures and negative tax expenditures may be explicit, that is, set out directly in the legislation, or implicit, arising from judicial decisions or administrative practices, thus involving different sources in each case.

The explicit tax expenditures and negative tax expenditures are obtained from Malaysian tax legislation that affects the ascertainment of liability to corporate income tax, namely the Income Tax Act 1967 (ITA 1967), the Promotion of Investments Act 1986 (PIA 1986), the Petroleum (Income Tax) Act 1967 (PITA 1967), the Labuan Business Activity Tax Act 1990 (LBATA 1990) and other federal gazette orders pertaining to income tax rules and regulations.

Implicit tax expenditures and negative tax expenditures are drawn from two sources. The first source is case law. Apart from Malaysian tax cases, this thesis also refers to English tax cases and tax cases from other Commonwealth countries such as Australia, Canada, Hong Kong, India, New Zealand and Singapore. Although only persuasive in their precedent value, these cases have always been referred to by Malaysian courts. This can be linked back to the history of Malaysia's tax law, the design of which was based on the *Model Colonial Territories Income Tax Ordinance of 1922*[15] which was also used by other British colonies. Many basic principles such as the definition of income[16] and the difference between capital and revenue expenditures[17] have been elucidated by these foreign courts' decisions.

The second source of implicit tax expenditures and negative tax expenditures is the Inland Revenue Board of Malaysia's (IRBM) administrative practices, which are gathered through the IRBM public rulings and guidelines. They represent the

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[15] Wong Sau Ngan, 'Post-Colonial Legal Developments' in Jomo Kwame Sundaram and Wong Sau Ngan (eds) *Law, Institutions and Malaysian Economic Development* (National University of Singapore Press, Singapore, 2008) 54, 68.

[16] *CIT v Shaw Wallace & Co* [1932] 6 ITC 178, *Kamakshya Narain Singh v CIT* [1943] 11 ITC 513.

[17] *Vallambrosa Rubber Co Ltd v Farmer* (1910) 5 TC 529, *British Insulated and Helsby Cables Ltd v Atherton* (1925) 10 TC 155.

interpretation of tax law of the Director General of Inland Revenue's (DGIR), and the policy and procedure to be applied. Although the public rulings and guidelines have no force of law,[18] the IRBM expects all taxpayers to abide by these practices. Thus they have become informal tax law and should therefore be subject to the same analysis as the formal tax legislation. In addition, guidelines produced by the governing body relating to a tax incentive are also referred to.

The financial accounting treatment is based on MFRSs, the accounting standards used in the preparation of financial statements, which together with accounting concepts and conventions comprise the basic principles used in accounting. The MFRSs are identical to the International Financial Reporting Standards (IFRSs) that are also adopted by most countries around the world, with full convergence having been completed on 1 January 2012 (with exception to the application of MFRS 141 *Agriculture* and Interpretation Committee (IC) Interpretation 15 *Agreements for the Construction of Real Estate*, where compliance is expected to start 1 January 2014).[19] This thesis concentrates only on income tax expenditures and negative income tax expenditures that relate to companies, to enable comparisons with accounting standards.

Corporate income tax expenditures in this thesis are categorised according to the objectives that they are seeking to achieve, and corporate negative income tax expenditures are categorised according to their known or supposed motives. The objectives for tax expenditures and motives of negative tax expenditures are gathered from the government's annual budget speeches. Where this is not possible, other sources including books, journals and parliamentary reports are used. When after a deliberate search no objective or motive is found, objectives have been assumed based on the construction and contents of the legislation itself.

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[18] *KPHDN v NV Alliance Sdn Bhd* [2010] MSTC ¶30-015 (High Court); *JPS v KPHDN* [2011] MSTC ¶10-031 (SCIT).

[19] FRF and MASB, 'Malaysia's Convergence with IFRS in 2012' (Press Release, 1 August 2008) <http://www.masb.org.my/index.php?option=com_content&view=article&id=1239:malaysias-convergence-with-ifrs-in-2012&Itemid=37>; MASB, 'MASB Issues Internationally Compliant Accounting Framework and New FRSs' (Press Release, 19 November 2011) <http://www.masb.org.my/index.php?option=com_content&view=article&id=1659:masb-issues-internationally-compliant-accounting-framework-and-new-frss-19-november-2011&catid=66&Itemid=37>; MASB, *Malaysian Financial Reporting Standards: Effective Date and Applicability* <http://www.masb.org.my/index.php?option=com_content&view=article&id=1649&Itemid=14>.

Given the changing nature of the tax legislation, case law and accounting standards, a cut-off date for data collection has been set at 30 June 2012. This means any changes after the cut-off date are not included in this thesis. Nevertheless, when changes are significant, a brief explanation is provided by way off footnote. This date has been chosen because by this date, Malaysia became convergent with most of the IFRSs, and most of the changes proposed in the 2012 Budget announcement, which was delivered on 7 October 2011, have been gazetted and become law.

1.7 CONTRIBUTIONS OF THE RESEARCH

This is the first research study to examine corporate income tax expenditures and corporate negative income tax expenditures in Malaysia. It is hoped that this study will increase awareness amongst the Malaysian government and populace of the use of tax expenditures as a tool to achieve social and economic policies. This thesis also constitutes a proposal to the Malaysian government and the legislature to consider amending certain tax laws that do not advance the country's social and economic policies, but rather a rigid interpretation of the tax law.

Among the main contributions of this thesis is the introduction of an alternative benchmark for corporate income tax expenditure analysis. This research study is the first of its kind to analyse tax expenditures and negative tax expenditures using accounting standards as the benchmark, tempered with anti-tax avoidance measures. Further arguments on this issue are discussed in Chapter Three.

While much other research focuses on tax expenditures, this thesis seeks to widen the current approach to include negative tax expenditures. These negative tax expenditures penalise certain groups of taxpayers or activities. Therefore it is essential to analyse them to determine whether the penalties imposed are appropriate to achieve certain policies, or whether they are flawed tax treatments that have caused injustice and therefore should be amended or abolished.

This thesis aims to extend the discussion of tax expenditures to include those arising from judicial decisions and administrative practices. Previous research has concentrated on tax expenditures derived solely from tax legislation. As these two sources have implicitly become tax rules, they should be subject to the same analysis as tax legislation.

1.8 SCOPE AND LIMITATIONS OF THE RESEARCH

While tax expenditure analysis can be carried out on all types of taxes, such as excise tax and sales and services tax, this thesis focuses only on corporate income tax. Thus data is collected from sources of tax law that are related only to the determination of corporate income tax.

One important component in a tax expenditure report is the measurement of tax expenditures, usually represented by the revenue lost as a result of the introduction of a particular tax expenditure. Unfortunately, due to the lack of publicly available data and restricted access to government data, this thesis could not produce the measurement of the tax expenditures and negative tax expenditures. Hence, the analysis of the tax expenditures and the negative tax expenditures is performed without considering their measurement.

As the corporate income tax expenditures and corporate negative income tax expenditures are categorised according to their objectives and motives, there are several tax expenditures and negative tax expenditures that could fit into more than one category. Where this occurs, a judgment is made as to the one category that best corresponds to the objective.

1.9 STRUCTURE OF THE RESEARCH

There are seven chapters in this thesis. Chapter Two provides a background to the history and development of accounting and taxation in Malaysia which is essential to an understanding of the further issues discussed in this thesis. Chapter Three explains the tax expenditure concept and the issues that revolve around it. This chapter also develops the benchmark tax structure to be used to identify corporate income tax expenditures and corporate negative income tax expenditures by using accounting standards as the benchmark tax base.

Chapters Four and Five identify economic and social corporate income tax expenditures in Malaysia respectively, while Chapter Six identifies corporate negative income tax expenditures. In each of these chapters, the tax expenditures and negative tax expenditures are analysed using the conventional tax expenditure analysis, to determine whether there is an apparent need for government intervention, if so whether regulation or subsidy or other government policy is best placed to achieve the desired outcome, if subsidies or support are an appropriate policy whether they are most effectively delivered as tax expenditures or through other mechanisms, particularly direct spending methods. The findings of this thesis are concluded in Chapter Seven, with a few recommendations for future research. Chapter Seven also offers recommendations to the government regarding the importance of tax expenditure analysis.

CHAPTER TWO

AN OVERVIEW OF FINANCIAL REPORTING AND TAX PRACTICES IN MALAYSIA

2.1 INTRODUCTION

This chapter contains information about accounting and taxation in Malaysia that is an essential background to discussions in the following chapters. Since this thesis uses accounting standards as the benchmark for identifying tax expenditures and tax disincentives, it is vital to understand how Malaysian accounting standards developed and why they are a reasonable proxy for the benchmark income tax. In addition, an understanding of the Malaysian income tax system provides basic knowledge which is required to understand the tax expenditure analysis.

The first part of this chapter explains the evolution of the accounting profession in Malaysia and the due process involved in the development of accounting standards; this part also demonstrates the accounting standards that have been carefully developed to represent company's performance. The second part of the chapter explains how the Malaysian tax system, which originated from the *British Tax Ordinance*, has gone through various developments and changes to arrive at its current state.

2.2 HISTORY OF THE ACCOUNTING PROFESSION AND DEVELOPMENT OF ACCOUNTING STANDARDS IN MALAYSIA

In the early years after Malaya's (as it was then known) independence from British rule in 1957, the preparation of financial statements in Malaysia was largely influenced by

the British accounting system.[20] This is to be expected as a majority of accountants during that time were trained in the UK and Australia.[21] Furthermore, although Malaya was politically independent, its economy was still dominated by the British, particularly through large British corporations such as Guthrie and Sime Darby.[22] The existence of these British corporations ensured the continuation of the British accounting system and also its auditing practice.

In Malaysia, prior to 1997, the standard setting process was left to the accounting profession. There are two accounting bodies that have governed the accounting profession in Malaysia. The Malaysian Institute of Certified Public Accountants (MICPA)[23] was established in 1958 as a self-regulating professional body, which provides technical guidance and training to its members, as well as conducting professional examinations to produce locally-trained professional accountants.[24] At the time of its establishment, MICPA had 20 members, all of whom had received education and training overseas.[25]

In 1967, the MIA was founded as a statutory body under the *Accountants Act 1967* to regulate and develop the accountancy profession in Malaysia.[26] Under this Act, only members of MIA are allowed to use the title "accountant". Thus, everyone who wishes to be an accountant must register as a member, even though he or she may already be a member of a professional accounting body such as Association of Chartered Certified

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[20] Azham Md Ali, Teck Heang Lee and Brian West, 'External Influences on the Development and Professionalisation of Accounting in Malaysia, 1957 - 1969' (Paper presented at the 2008 Accounting and Finance Association of Australia and New Zealand Conference, Sydney, Australia, 6-8 July 2008) 26-27 <http://www.afaanz.org/openconf/2008/modules/request.php?module=oc_proceedings&action=view.php&a=Accept+as+Paper&id=530>.

[21] Selvaraj D Susela, '"Interest" and Accounting Standard Setting in Malaysia' (1999) 12(3) *Accounting, Auditing and Accountability Journal* 358, 361.

[22] Md Ali, Lee and West, above n 20, 10.

[23] Originally known as the Malayan Association of Certified Public Accountants, which later changed its name to the Malaysian Association of Certified Public Accountants in 1964. In 2002, its name was again changed to the Malaysian Institute of Certified Public Accountants (Source: <http://www.micpa.com.my/micpamember/public/aboutus.asp>).

[24] Suhaida Mohd Sood, *Setting the Financial Accounting Standards in Malaysia: The Malaysian Accounting Standards Board (MASB) and the Accounting Profession 1997-1999* (Masters Thesis, Lincoln University, 2006) 6 <http://researcharchive.lincoln.ac.nz/dspace/bitstream/10182/2260/5/sood_mcm.pdf >.

[25] Takiah Mohd Iskandar and Hamid Pourjalali, 'Cultural Influences on the Development of Accounting Practices in Malaysia' (2000) 8(2) *Asian Review of Accounting* 126, 129.

[26] MIA, *About MIA*, <http://www.mia.org.my/new/about.asp>.

Accountants (ACCA), Institute of Chartered Accountants of England and Wales (ICAEW) or even MICPA. During the first 20 years after its formation, MIA developed very slowly and functioned only as a body that registers practicing accountants, until it was reactivated in 1987.[27]

As MIA failed to perform its function as the regulator of the accounting profession, MICPA continued to dominate, including in the standard setting process.[28] After the International Accounting Standards (IASs) were first published in 1975 by the International Accounting Standards Committee (IASC), MICPA carried out the role of reviewing these standards for their adoption as approved accounting standards in Malaysia. The IASC, established in 1973,[29] is the international standard setting body that was established to promote the harmonisation of accounting practice.[30] MICPA started to adopt IASs as approved accounting standards in 1977.[31] In areas where no IAS was applicable, or an IAS was contrary to local legislation, MICPA issued its own guidelines, known as Malaysian Accounting Standards (MASs), to be followed by its members.[32]

When MIA was reactivated in 1987, it accepted all accounting standards previously approved by MICPA. Between 1987 and 1992, MIA and MICPA worked together through a joint committee in the adoption of IASs, and in the issuance of MASs in areas where no IASs are applicable.[33] The joint committee was dissolved in 1992 after a dispute between the two bodies regarding the adoption of MAS 6 *Accounting for Goodwill*. MIA continued with its stand in favour of adoption of the standard, while

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[27] Susela, above n 21, 362.

[28] Susela, above n 21, 362; Mohd Sood, above n 24, 7.

[29] At the time of its establishment, IASC had representatives from the accounting bodies of nine countries - Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom/Ireland, and the United States. Later, more accounting bodies from countries around the world joined IASC, including Malaysia's MICPA and MIA.

[30] Deloitte, *Chronology of the IASC and the IASB*, IAS Plus, <http://www.iasplus.com/restruct/chrono.htm>.

[31] Shahrokh M Saudagaran and Joselito G Diga, 'The Institutional Environment of Financial Reporting Environment in ASEAN' (2000) 35(1) *The International Journal of Accounting* 1, 7.

[32] Susela, above n 21, 363.

[33] For example, MAS 1 Earnings Per Share, MAS 2 Accounting for Acquisition and Mergers, MAS 3 Accounting for General Insurance Business, MAS 5 Accounting for Aquaculture, MAS 7 Accounting for Property Development.

MICPA chose to defer its adoption. With two different standpoints, local accountants were left confused.[34]

Following the dispute between the two accounting bodies, the government decided to take the standard setting activity out of the hands of the profession. In 1997, under the newly enacted *Financial Reporting Act 1997*, the Malaysian Accounting Standards Board (MASB) was established as an independent standard setting body. The board consists of eight members who have knowledge and experience in the financial reporting field. Under the same legislation, the Financial Reporting Foundation (FRF) was also created as a trustee body with the function to oversee the operation of MASB. The FRF is not involved in the standard setting process. The FRF has 12 members, who include representatives from various government bodies, public listed companies, public accounting firms and the MIA itself.[35]

The new legislation has also made it compulsory for financial statements to be prepared in accordance with approved accounting standards.[36] Previously, the accounting standards issued by MIA and MICPA were binding only on their members, that is, the accountants. In case of non-compliance, these accounting bodies can take disciplinary action against their members. However, the directors of companies will not be held responsible. Following the enactment of *Financial Reporting Act 1997*, the *Companies Act 1965* has also been amended. The amendment requires all companies to comply with approved accounting standards, and places responsibility on the shoulders of the directors.[37]

Since its establishment in 1997, MASB has issued its own accounting standards, known as MASB standards. These accounting standards are consistent with IASs (except for locally developed standards), but MASB has made enhancements by including

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[34] Susela, above n 21, 363-366.

[35] MASB, *Financial Reporting Foundation* <http://www.masb.org.my/index.php?option=com_content&view=article&id=1&Itemid=5>.

[36] *Financial Reporting Act 1997* s 26D.

[37] *Companies Act 1965* s 166A.

explanations, guidance and examples to enhance their clarity.[38] In 2001, as a result of a restructuring, the IASC was replaced by the International Accounting Standards Board (IASB). The IASB has issued new international accounting standards to replace IASs, known as the IFRSs. Many countries have already adopted, or are in the process of adopting, IFRSs.

Malaysia has joined other countries in adopting IFRSs, with full convergence for Malaysia took place from 1 January 2012 (with exception to the application of MFRS 141 *Agriculture* and IC Interpretation 15 *Agreements for the Construction of Real Estate*, where compliance is expected to start on 1 January 2014).[39] Since January 2006, MASB has revised its accounting standards by removing the enhancements that have been incorporated into the MASB standards, so that the standards will be identical word-for-word to IFRSs. The name used for the standards has also been changed from MASB standards to MFRSs. Most IFRSs have been adopted since then, except for a few standards that have not previously been adopted by MASB.[40]

Consistent with the adoption of IFRSs, Malaysia also adopted the two-tier financial reporting system applied by IASB, commencing in 2006. The two-tier system allows the use of a different set of accounting standards, known as Private Entity Reporting Standards (PERSs), to be applied by private entities. These private entities are privately run small and medium companies. The use of PERSs, which are much simpler than IFRSs, can reduce the compliance burden of private entities. However, they are given the choice to use either PERSs or IFRSs. Whichever standards are chosen, they need to be applied consistently and in their entirety in the preparation of financial statements.[41]

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[38] MASB, 'MASB Issues 10 Revised Accounting Standards and New Accounting Framework' (Press Release, 15 June 2007) <http://www.masb.org.my/index.php?option=com_content&view=article&id=525:10-revised-accounting-standards&catid=37&Itemid=37>.

[39] FRF and MASB, above n 19; MASB, 'MASB Issues Internationally Compliant Accounting Framework and New FRSs', above n 19; MASB, *Malaysian Financial Reporting Standards: Effective Date and Applicability,* above n 19.

[40] Carolyn Canham, 'Malaysian Standard Setter to Complete IFRS by 2012' (2008) (August) *The Accountant* <http://www.theaccountant-online.com/news/malaysian-standard-setter-to-complete-ifrs-adoption-by-2012>.

[41] MASB, 'MASB: FRS Now Optional for Private Companies' (Press Release, 23 Feb 2006) <http://www.masb.org.my/index.php?option=com_content&view=article&id=564:frs-now-optional&catid=38:press-release-2006&Itemid=37>.

2.3 THE DUE PROCESS FOR DEVELOPMENT OF ACCOUNTING STANDARDS

Since the introduction of accounting standards in 1970s, the standards have been regularly reviewed and updated to ensure high quality financial reporting that can suit the fast changing business environment. The standard setting process is a long process that normally takes more than one year before a standard can be officially published. An important part of the process is to invite all interested parties, including auditors, company directors, investors, academics, accounting bodies, analysts, the government and interested individuals, to take part, by giving their views and comments on the new proposed standard. This is to ensure the new standard is accepted by all parties, and to minimise post-implementation issues. As the role of IASB is to develop a globally-accepted set of standards, the Board has a challenging responsibility to accommodate these comments in the standard.

The due process starts when IASB identifies an issue that requires a new standard or alteration to an existing standard. This issue might be raised by IASB staff, or it could be as a result of a recommendation by external parties, or it could be due to changes in the accounting conceptual framework. After investigations by its staff and consultations with the IFRS Advisory Council and other standard setting bodies, IASB decides whether to proceed with the issue as part of its agenda.[42]

Once an issue has been included on the IASB's agenda, a working group may be established. The selection of members of a working group depends on how extensive the issue is. If IASB decides to omit the working group, a reason must be stated. On some occasions the working group may be a joint project with other standard setting bodies.[43]

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[42] IFRS Foundation, *Due Process Handbook for the IASB* (February 2012), paras 19-26.
[43] IFRS Foundation, *Due Process Handbook for the IASB*, above n 42, paras 27-29.

The next stage in the standard setting process is the development and publication of a discussion paper. This stage is not mandatory for IASB; however, it is a normal practice and IASB needs to state a reason if it is to be omitted. The discussion paper is the first publication released to the public with regard to an issue, and the public are invited to give comments and recommendations. Normally, the time allowed for submissions is 120 days, but it may be longer. All comments are analysed by IASB and posted on its website. If further comments are required, IASB may conduct field visits, or arrange public hearings and round table meetings with interested parties.[44]

Based on comments received in response to the discussion paper and at meetings with interested parties, the next stage is the publication by IASB of an exposure draft. This is a mandatory stage. An exposure draft is published as a proposed standard, to follow the format of an actual standard. The draft may also include other information that can assist readers to better understand the issue, such as application and implementation guidance, the basis for conclusions on proposals and dissenting views. Again, at this stage, the public are invited to give comments, usually within 120 days. All comments and a summary are posted on the website. Field visits, public hearings and round table meetings are arranged if necessary, to acquire more feedback.[45]

The IASB may issue a second exposure draft if there are unresolved issues in relation to the first exposure draft, following the same due process. Before continuing to draft an IFRS, the IASB is required to prepare a project summary and feedback statement. This statement gives direct feedback to comments received from the exposure draft, and explains the most significant issues raised and how they were responded to. In addition, the IASB also prepares an analysis of the possible effect of implementing the new IFRS, which includes implementation costs, ongoing costs, and how the new IFRS can improve the quality of financial statements. After all issues have been resolved, and a conclusion can be reached, an IFRS can then be drafted. The draft IFRS is reviewed by an external party, normally by the IFRS Interpretations Committee,[46] to check for any

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[44] IFRS Foundation, *Due Process Handbook for the IASB*, above n 42, paras 30-37.

[45] IFRS Foundation, *Due Process Handbook for the IASB*, above n 42, paras 38-44.

[46] The IFRS Interpretations Committee is the interpretative body of the IASB. Its scope is to review accounting issues of widespread importance that have arisen from current published IFRSs, and to publish authoritative guidance, known as IFRIC Interpretations.

'fatal flaw'. It is also posted on the website, but limited only to paying subscribers. Finally, after IASB members have balloted in favour of publication, the IFRS is issued. The project summary and feedback statement and analysis of possible effect are published afterwards.[47]

After the issuance of an IFRS, the IASB holds various events to cater for any post implementation problems. These include meeting with interested parties, including other standard setting bodies, and educational activities to assist preparers to better understand the new standard. Ongoing reviews are held within two years after implementation for any unexpected complications.[48]

2.4 THE EVOLUTION OF THE MALAYSIAN INCOME TAX SYSTEM

The income tax system in Malaysia is hugely influenced by the British tax system, particularly because Malaysia was once under British colonial rule. Before examining how the Malaysian income tax system evolved to reach its current form under the ITA 1967, it is useful to review briefly the history of Malaysia during the colonial period.

British administration came to Penang as early as 1786.[49] By the end of the 19th century, the British controlled many states in Malaya (currently Peninsular Malaysia). These states were grouped into three categories. The Straits Settlements, established in 1824,[50] were governed directly by the British Colonial Office through a British governor.[51] The Federated Malay States, formed in 1896, maintained the Malay Kings as the rulers in each state, but received British state Residents and were headed by a Resident-General.[52] Then there were the Unfederated Malay States, which received British advisers but were not tied to a centralised government, and so the Malay Kings

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47 IFRS Foundation, *Due Process Handbook for the IASB*, above n 42, paras 45-51; 76-83.
48 IFRS Foundation, *Due Process Handbook for the IASB*, above n 42, paras 52-53.
49 Neil Joseph Ryan, *The Making of Modern Malaya: A History from Earliest Times to Independence* (Oxford University Press, Kuala Lumpur, 2nd ed, 1965) 80.
50 Ryan, above n 49, 92.
51 Ryan, above n 49, 110.
52 Ryan, above n 49, 133-135.

in these states had greater power and were more independent.[53] The British government proposed to gradually combine these three groups of states. However the plan was suspended when the Japanese invaded Malaya in 1941.[54] After the end of World War II, the British returned to Malaya and in 1946 proposed the idea of a Malayan Union which would combine all states including the Straits Settlements (except for Singapore), Federated Malay States and Unfederated Malay States under one central administration. The idea of Malayan Union was strongly opposed (for reasons other than tax) and was eventually dropped. It was replaced by the Federation of Malaya two years later, under which all states except for Singapore were centralised.[55]

The very first attempt by the British to introduce an income tax was made in the Straits Settlements, the area in which they had absolute control. A draft bill on implementation of income tax was presented to the Straits Settlements Legislative Council in 1910. However, due to strong opposition from the public, the bill was withdrawn. Nevertheless, the British government believed income tax was a proper way to raise revenue and hence, in 1916, proposed another income tax bill. This time, the tax was successfully implemented between 1917 and 1919 as a temporary war tax, to help support efforts in the war conditions encountered by the British. In 1920, the *War Tax Ordinance* was converted into the *Income Tax Ordinance*, but the tax collected was still used to support the war efforts. Owing to strong opposition, in 1922 the *Income Tax Ordinance* was repealed. No form of income tax was subsequently introduced in Malaya between 1923 and 1940.[56]

In 1940, the British administration announced another plan to impose an income tax. Again, there was opposition from the public. The proposal was abandoned, but only for a short period. Later in the same year, the government formed a joint committee to draft tax Bills for the Straits Settlements and the Federated Malay States. The draft was based on the *War Tax Ordinance 1919*, and intended to be imposed for only one year,

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[53] Ryan, above n 49, 138-142.
[54] Ryan, above n 49, 160-162.
[55] Ryan, above n 49, 191-194.
[56] Anna A Che Azmi, 'The Development of the Relationship between Accounting and Taxation during the Colonial Period: The Case of Malaysia' (Paper presented at the 2007 Accounting, Business and Financial History Conference, Cardiff Business School, 10 – 11 September) 4-6; CCH, *Malaysian Tax Reporter* (at 13 June 2011) ¶805.

assuming annual adoption of new tax Bills. Separate Bills, effective 1 January 1941, were passed for the Straits Settlements[57] and the Federated Malay States.[58] Their contents were identical in many respects. The Bills for 1942 were drafted and passed, but due to the invasion by the Japanese, they were short-lived. However, it was reported that the government managed to collect some income tax in the Straits Settlements during the Japanese occupation period.[59]

After the end of the Japanese occupation in 1945,[60] the British administration once again sought to introduce income taxation. However, due to instability in the economy during that time, the plan was deferred.[61] In 1947, the British government appointed R B Heasman, a tax expert from the British Inland Revenue Office, to investigate whether income tax was a practical tax policy for Malaya and Singapore.[62] His comprehensive report, known as the Heasman Report, which was published in August 1947, concluded that an increase in revenue was "urgent, important and vital", and that income tax was the only way to achieve this.[63] Eventually, the *Income Tax Ordinance 1947*, based on the *Model Colonial Territories Income Tax Ordinance 1922*, was passed for Malaya and Singapore, effective 1 January 1948.[64] Heasman himself was appointed as the first Comptroller for Income Tax for Malaya and Singapore.[65]

The formation of Malaysia in 1963 saw Malaya combined with Sabah and Sarawak from Borneo, and Singapore (which left the federation in 1965). Since Sabah and Sarawak had their own tax legislation,[66] measures were taken to harmonise the tax

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57 *Straits Settlements Ordinance No 3 1941*.

58 *War Tax Enactment No 5 1941*.

59 Che Azmi, above n 56, 6-7; CCH, *Malaysian Tax Reporter*, above n 56, ¶805.

60 Ryan, above n 49, 188.

61 Che Azmi, above n 56, 8.

62 'Income Tax Man Named', *The Straits Times* (Singapore), 3 January 1947, 5 <http://newspapers.nl.sg/ Digitised/Article.aspx?articleid=straitstimes19470103.2.67>.

63 'The Heasman Report – 1', *The Straits Times* (Singapore), 20 August 1947, 4 <http://newspapers.nl.sg/ Digitised/Article.aspx?articleid=freepress19470820.2.43>.

64 CCH, *Malaysian Tax Reporter*, above n 56, ¶805; Veerinderjeet Singh, *Veerinder on Taxation,* (Arah Publications, 2008) vol 1, 5.

65 'Tax Officers Gazetted', *The Straits Times* (Singapore), 22 February 1948, 5 <http://newspapers.nl.sg/ Digitised/Article.aspx?articleid=straitstimes19480222.2.60>.

66 *Income Tax Ordinance 1956 of Sabah*, *Inland Revenue Ordinance 1960 of Sarawak*.

system. Subsequently, the ITA 1967 was passed, which was effective from 1 January 1968 and still remains in effect to this day.[67]

The collection of income tax was administered by Income Tax Department, renamed the Inland Revenue Department after Malaya's independence in 1957. Despite independence from Britain, the post of Comptroller General continued to be held by foreigners until 1967, when a Malaysian was appointed as the Director General of the Inland Revenue Department. In 1996, following the enactment of the *Inland Revenue Board of Malaysia Act 1995*, the department was upgraded to a statutory body and its name changed to the IRBM.[68]

2.5 THE CURRENT STATE OF THE INCOME TAX SYSTEM IN MALAYSIA

2.5.1 General Principles

Two types of tax are levied in Malaysia – direct tax and indirect tax. The collection of direct tax, which includes individual income tax, corporate tax, real property gains tax (RPGT) and stamp tax, is controlled by the IRBM. Indirect tax, which consists of sales tax, service tax, customs duties and excise duty, is governed by the Royal Malaysian Customs Department. Customs duties comprise import duties and export duties.

In Malaysia, income tax is assessed on a territorial basis. Only income accruing in or derived from Malaysia is chargeable to tax. Foreign income is not taxable. This rule is applicable to both resident and non-resident persons, including companies, with the exception of resident companies involved in banking and sea and air transportation.[69] These companies are assessed on worldwide basis, which means all income, wherever derived, is chargeable to tax in Malaysia.[70]

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[67] Che Azmi, above n 56, 12.
[68] IRBM, *IRBM Annual Report 2008*, 18-19.
[69] ITA 1967 sch 6 para 28.
[70] ITA 1967 ss 60C, 54(2)(a).

Resident individuals are taxed at a scale of rates and, beginning 2010, the taxable rates are between zero and 26 per cent. Those with higher income are taxed at a higher rate.[71] Non-resident individuals are taxed at a flat rate of 26 per cent. Effective 2009, both resident and non-resident companies are taxed at a flat rate of 25 per cent. Resident companies with paid up capital not exceeding MYR 2.5 million (AUD 833,000) enjoy a lower tax rate of 20 per cent for the first MYR 500,000 (AUD 167,000) of taxable income.

The determination of resident status for individuals is based on a quantitative approach, depending on the number of days spent by the individual in Malaysia.[72] A company is resident in Malaysia if at any time during the basis year, the management and control of its business or any of its businesses are exercised in Malaysia.[73] The term 'management and control' normally refers to meetings of the board of directors. However, as the term is not specifically defined by the legislation, its interpretation derives from case law.[74] The advantages of being a resident company include entitlement to receive investment incentives and enjoyment of the benefits of double tax agreements with other countries.

2.5.2 Ascertainment of Chargeable Income for Companies

The corporate tax rate of 25 per cent is imposed on chargeable income. Section 4 of the ITA 1967 specifies the following types of income that are chargeable to income tax, applicable to both resident and non-resident taxpayers:

a) Gains or profits from a business, from whatever period of time carried on;
b) Gains or profits from an employment;
c) Dividends, interest or discounts;
d) Rents, royalties or premium;
e) Pensions, annuities or other periodical payments not falling under any of the foregoing paragraphs; and
f) Gains or profits not falling under any of the foregoing paragraphs.

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[71] Individuals with chargeable income lower than MYR2,500 (AUD 830) are taxed at zero per cent, and chargeable income that exceeds MYR100,000 (AUD 33,000) are taxed at 26%. The complete income tax rate schedule for resident individuals is available in IRBM website at <http://www.hasil.gov.my/goindex.php?kump=5&skum=1&posi=2&unit=5000&sequ=11>.

[72] The specific rule is provided in ITA 1967 s 7.

[73] ITA 1967 s 8.

[74] For further discussion on this issue, see Singh, *Veerinder on Taxation,* vol 1*,* above n 64, 273-279.

In addition, section 4A of the ITA 1967 specifies three special classes of income that will be taxable if derived by a non-resident person:

(i) amounts paid in consideration of services rendered by the person or his employee in connection with the use of property or rights belonging to, or the installation or operation of any plant, machinery or other apparatus purchased from, such person;
(ii) amounts paid in consideration of technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme; and
(iii) rent or other payments made under any agreement or arrangement for the use of any moveable property.

Expenses that are allowed to be deducted from these types of income are based on the general deduction rule as stipulated in section 33(1) of the ITA 1967:

> Subject to this Act, the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person from that source for that period all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of gross income from that source, including…

Apart from the general deduction rule, there are allowances and other deductions that must be taken into account before arriving at chargeable income. The computation of total/chargeable income involves the following adjustments. It should be noted that the following are the general adjustments:

Gross income

Less: Allowable expenses [ITA 1967, s 33(1)]

Double deduction of expenses

Special deductions [ITA 1967, s 34(6)]

Adjusted income [ITA 1967, s 33]

Add: Balancing charges

Less: Capital allowances [ITA 1967, sch 3]

Balancing allowances

Statutory income [ITA 1967, s 43]

Less: Pioneer status income exemption/Investment tax allowance [PIA 1986]

Reinvestment allowance [ITA 1967, sch 7A]

Unabsorbed business losses from previous years

Add: Statutory income from other sources

Aggregate income [ITA 1967, s 43]

Less: Current year business losses

Approved donations and business *zakat*[75]

Pre-operational business expenses

Total income/Chargeable income [ITA 1967, s 44]

This overview does not include some further adjustments discussed in detail in Chapters Four and Five.

Since tax law does not use any accounting measurements, there is no direct link between net accounting profits and chargeable income. Specific adjustments described further in Chapters Four and Five are made at different stages of the calculation of chargeable income or tax payable.

[75] *Zakat* is a religious charity donation that must be paid by Muslims. Under ITA 1967, s 44(11A), a company that paid business *zakat* to an appropriate religious authority is eligible for a deduction, but of an amount limited to 2.5% of aggregate income. 2.5% is the standard rate used to calculate *zakat* payable.

2.5.3 Sources of Tax Law

There are three sources of tax law that may be referred to in order to resolve tax issues. Two of them are formal law, and the third one is an informal source of tax law. The first one, a written formal law, is the tax legislation. This is the law that has been enacted in the Parliament. The principle laws within the control of the IRBM include the ITA 1967, PIA 1986,[76] *Real Property Gains Tax Act 1976*, PITA 1967, *Stamp Act 1949* and LBATA 1990. In addition, there is also subsidiary legislation such as exemption orders and tax rules and regulations that are tabled by the Minister of Finance in the yearly Budget speech.[77]

The second source is the case law, a non-legislated formal law. Case law based on court decisions assists in the interpretation of the legislation. For example, there are many terms in the ITA 1967 which were left undefined, such as the terms 'income' and 'plant'. What falls within the scope of these terms is placed in the hand of judges. On some occasions, different judges may have different opinions. Furthermore, Malaysia also applies the doctrine of precedent, where, in cases with similar circumstances, courts are bound to apply their own previous decisions and the decisions of higher courts. Given Malaysia's British colonial history, it is common for Malaysian courts to refer to cases from other Commonwealth countries, such as Singapore, Australia, New Zealand, Hong Kong and the UK itself. However, Malaysian courts are not legally bound to apply these foreign cases, except for decisions of the Privy Council prior to 1985. Effective 1 January 1985, civil appeals, including tax appeals, to the Privy Council were abolished. Therefore, decisions made by the Privy Council after this date have no binding effect on Malaysian courts.

In Malaysia, any dispute between a taxpayer and the DGIR is first heard by the Special Commissioners of Income Tax (SCIT), a court that deals specifically with income tax matters. An appeal from a decision of the SCIT is brought before the High Court, and a further appeal may be heard by the Court of Appeal. The highest court in the hierarchy

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[76] The PIA 1986 offers various investment incentives and is applied within the ITA 1967.

[77] Singh, *Veerinder on Taxation,* vol 1, above n 64, 18-19.

is the Federal Court, which hears appeals from decisions made by the Court of Appeal. Decisions of the Federal Court are final. No further appeals are allowed.

The informal source of tax law is the practice of the IRBM. This includes the IRBM's assessment and review procedures, and day-to-day practices. It also includes various rulings and guidelines issued by the IRBM.[78] The most common is the public ruling. A public ruling describes how a particular tax law is interpreted by the DGIR, together with the policy and procedure that should be applied.[79] The DGIR is empowered under section 138A of the ITA 1967 to issue a public ruling and apply it accordingly. The public ruling does not have any legal effect;[80] however it has become an accepted "law".[81] Nevertheless, if the matter is brought to court, it is for the court to interpret the law based on the legislation and case law.

2.6 SUMMARY

The use of accounting standards to measure company performance continues to receive worldwide recognition. In Malaysia, accounting standards are recognised by the government and are legally enforced. Generally, users, especially capital providers,[82] accept financial statements as a reliable source of information to make financial decisions. The thorough process involved in setting a standard is evidence of its high quality. The net income as shown in the financial statements of a company reflects the company's performance for the period, and hence can be a good proxy for the benchmark income tax, that is, the base for a normative structure of income tax (as proposed by this thesis).

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[78] Singh, *Veerinder on Taxation* vol 1, above n 64, 20.

[79] IRBM, *Public Rulings* (12 April 2011) <http://www.hasil.gov.my/goindex.php?kump=5&skum=5&posi=3&unit=1&sequ=1>.

[80] *KPHDN v NV Alliance Sdn Bhd* [2010] MSTC ¶30-015 (High Court); *JPS v KPHDN* [2011] MSTC ¶10-031 (SCIT).

[81] Singh, *Veerinder on Taxation,* vol 1, above n 64, 20.

[82] Capital providers include potential and current investors, financial institutions and other creditors.

The Malaysian income tax system derives from the British tax system, and thus has some similarities with the tax system of other Commonwealth countries. While the legislation appears fundamentally different, Malaysian courts have used British concepts to interpret Malaysian law and the fundamental British principles are thus reflected in Malaysian tax law, particularly the characterisation of gains as capital gains or income receipts, and of outgoings as revenue or capital expenses. The system is put into practice based on the interpretation of the IRBM.

Although both accounting and taxation focus on the determination of net income, they are two separate systems. They also have different objectives. It is an accepted principle that accounting evidence may be referred to by the court in a tax case, but the court is never bound by it.[83] The inherent differences between accounting and taxation practices are discussed in Section 3.5.

[83] *International Investments Ltd v CGIR* (1975) 2 MLJ 208.

CHAPTER THREE

THE BENCHMARK TAX BASE TO IDENTIFY CORPORATE TAX EXPENDITURES: A PROPOSAL TO USE ACCOUNTING STANDARDS

3.1 INTRODUCTION

Ever since the concept of tax expenditures emerged in the late 1960s, the issue of defining the benchmark tax base for tax expenditure analysis has been the central discussion. The adoption of the first tax expenditure budget in the United States required a definition of the benchmark that would be used to identify features in the tax law that led to over- or under-taxation compared to the tax that would follow with application of the benchmark. For over four and a half decades there has been disagreement about the benchmark developed by the Treasury for the purpose of the US tax expenditure budget. The Australian benchmark, in use for three decades, is also an *ad hoc* creation of the Australian Treasury and each year's iteration of that country's tax expenditure statement contains an explanation for the borderlines drawn in the course of developing the benchmark.[84] New Zealand, on the other hand, does not attach itself to a single normative tax benchmark and has not specified any tax base to be adopted, but rather provides a set of "guiding criteria" to identify tax expenditures.[85]

Each proposed benchmark tax base has its own proponents and opponents, but only a few proposals are convincing and are applied in tax expenditure reports. Previously, the issue has been explored mainly by tax experts from economics and law. There is yet to be any accounting scholar give an opinion on this matter. The aim of this chapter is to propose the use of accounting standards as an alternative benchmark tax base to identify corporate tax expenditures, particularly for Malaysia, which to date has not published any formal or informal tax expenditure report.

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[84] Australian Treasury, *Tax Expenditures Statement 2011* (January 2012) 214-218.

[85] New Zealand Treasury, *2012 Tax Expenditure Statement*, 2012 Budget (24 May 2012) 2-3.

This chapter first explores the concept of tax expenditures and analyses the issues that revolve around it, which includes the benefits and shortcomings of such expenditures as compared to direct spending programs, the measurement of tax expenditures and tax expenditure reporting. The chapter then discusses the previous proposed tax bases that have been offered by various scholars. This chapter later develops arguments to support the use of accounting standards as the benchmark tax base, followed by a discussion of the sources of differences between accounting income and taxable income. Finally, this chapter reveals the proposed benchmark for Malaysia's corporate tax expenditure reporting and analysis.

3.2 TAX EXPENDITURES

3.2.1 History and Background

The concept of tax expenditures was brought to light by the late Professor Stanley S Surrey; a tax expert, tax enthusiast and tax reformist who had spent most of his life in the field of taxation. His contribution to tax policy started in the 1930s, at which time he started to publish tax articles. He commenced as an attorney at the Office of the Tax Legislative Council in the US Treasury Department, and later joined Berkeley Law as a professor in 1947. In 1950, he joined Harvard Law School. He left his academic position in 1961 to serve as the Assistant Secretary of the US Treasury for Tax Policy. In 1969, he quit the public service and returned to Harvard Law School as a professor until his retirement. His vigorous works in the area of tax expenditure continued until his death in 1984.[86]

It was during his tenure as the Assistant Secretary with the US Treasury that Surrey posited the idea of the tax expenditure, and turned it into a concept capable of practical application. The issue arose after the US government, in its struggle to increase tax collection and to reduce expenditures, failed to consider tax expenditures due to the lack

[86] Erwin N Griswold, 'In Memoriam: Stanley S. Surrey: A True Public Servant' (1984) 98(2) *Harvard Law Review* 329, 329-330.

of awareness that tax expenditures are a substitute for direct spending and the absence of any kind of data or analysis on that matter.[87] The idea was first conveyed by Surrey on 15 November 1967, before the Money Marketeers, a New York financial group, in a speech entitled 'The United States Income Tax System – the Need for a Full Accounting',[88] which was followed by many other books and journal articles authored by Surrey and his colleagues.[89]

Since the 1950s, tax scholars have expressed their concern about the rising number of tax incentives which could have a negative impact on the tax system.[90] In the 1960s, the US Treasury supported this notion, and contended that direct spending is a better measure to achieve the same objectives these tax incentives are trying to achieve.[91] While both tax incentives and direct spending programs can be used to achieve a particular policy, there is a lack of comprehensive analysis over tax incentives and how much the use of these incentives costs the government. Therefore the Treasury, led by Surrey himself, started to compile a list of tax expenditures together with an estimate of the revenue forgone (which is equivalent to the amount spent by the government if the incentive is delivered as direct expenditure).[92] The outcome of this study was published

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87 Surrey, *Pathways to Tax Reform*, above n 3, 1-2; Daniel N Shaviro, 'Rethinking Tax Expenditures and Fiscal Language' (2004) 57(2) *Tax Law Review* 187, 200-201.

88 Surrey, *Pathways to Tax Reform,* above n 3*,* 3; Surrey and Hellmuth, above n 3, 528.

89 See Surrey and Hellmuth, above n 3; Stanley S Surrey, 'Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures' (1970) 83(4) *Harvard Law Review* 705; Surrey, 'Federal Income Tax Reform', above n 2; Surrey, 'Tax Subsidies as a Device for Implementing Government Policy', above n 11; Surrey, *Pathways to Tax Reform*, above n 3; Surrey, 'At Home: Tax Expenditures', above n 11; Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11; Surrey, 'Tax Expenditure Analysis: The Concept and Its Uses', above n 12; Surrey and McDaniel, 'Tax Expenditure Concept: Current Developments and Emerging Issues', above n 11; Stanley S Surrey and Paul R McDaniel, 'The Tax Expenditure Concept and the Legislative Process' in Henry J Aaron and Michael J Boskin (eds), *The Economics of Taxation* (The Brookings Institution, 1980) 123; Maktouf and Surrey, above n 11; Surrey and McDaniel, *Tax Expenditures*, above n 11; Paul R McDaniel and Stanley S Surrey, *International Aspects of Tax Expenditures: A Comparative Study* (Kluwer Law and Taxation Publishers, 1985).

90 Stanley S Surrey, 'The Congress and the Tax Lobbyist – How Special Tax Provisions Get Enacted' (1957) 70(7) *Harvard Law Review* 1145, 1146.

91 Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 681; Surrey and McDaniel, *Tax Expenditures*, above n 11, 2.

92 Surrey and McDaniel, *Tax Expenditures*, above n 11, 2-3; Surrey and Hellmuth, above n 3, 529-530.

in the 1968 Secretary of the Treasury's Annual Report, and was the first tax expenditure budget produced.[93]

There were a number of motivating factors for Surrey to uphold the idea of the tax expenditure. First was his persistent effort to promote tax fairness. He believed that everyone must be taxed based on their ability to pay.[94] Tax expenditures provide incentives only to certain groups or activities, and thus affect tax fairness. Moreover, due to a lack of analysis, some tax expenditures will provide most benefits to the higher bracket taxpayers, who obviously are not the needy group.[95]

The second factor was to enhance transparency. While direct spending programs are subjected to detailed scrutiny, tax incentives, though are actually alternatives to direct spending, are implemented without the necessity of going through the same process.[96] In addition, since the provisions of tax incentives are embedded as part of tax law, the public are not aware of their existence.[97] Surrey also highlighted how a tax office, apart from their well-known function as the revenue-raising agency, is also a medium used by the government to spend money through tax incentives. He believed that the public deserve to be informed about these facts.[98] The tax expenditure report pioneered by Surrey has become a mechanism for the public to assess these incentives.

The third factor motivating Surrey to promote this concept was to help government improve its tax and budgetary policies. By acknowledging the existence of tax

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[93] Bernard Wolfman, 'Tax Expenditures: From Idea to Ideology' (1985) 99(2) *Harvard Law Review* 491, 494; Surrey and Hellmuth, above n 3, 529; Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 681; Maktouf and Surrey, above n 11, 741.

[94] Richard A Musgrave, 'Pathway to Tax Reform' (1984) 98(2) *Harvard Law Review* 335, 335-336.

[95] Surrey, 'The Congress and The Tax Lobbyist – How Special Tax Provisions Get Enacted', above n 90, 1156; Surrey, 'Federal Income Tax Reform', above n 2, 360; Surrey, 'Tax Incentives as a Device for Implementing Government Policy', above n 89, 720-723; Eric J Toder, 'Tax Cuts or Spending – Does it Make a Difference?' (2000) 53(3, Pt 1) *National Tax Journal* 361, 366.

[96] Surrey, 'Tax Incentives as a Device for Implementing Government Policy', above n 89, 726; Surrey, 'At Home: Tax Expenditures', above n 11, 54; Julie Smith, 'Tax Expenditures: the $30 Billion Twilight Zone of Government Spending' (Research Paper No 8 2002-03, Department of the Parliamentary Library, 2003) 5-6; Leonard E Burman and Marvin Phaup, 'Tax Expenditures, the Size and Efficiency of Government, and Implications for Budget Reform' (NBER Working Paper No 17268, National Bureau of Economic Research, 2011) 25.

[97] Surrey, 'The Congress and The Tax Lobbyist – How Special Tax Provisions Get Enacted', above n 90, 1175.

[98] Surrey and McDaniel, *Tax Expenditures*, above n 11, 1.

expenditures within the tax system of a country, and with adequate analysis of these tax expenditures, government should be able to formulate better policies.[99] The information provided by this analysis should assist the government to better manage its funds.

3.2.2 The General Concept of the Tax Expenditure as Posited by Stanley S Surrey

Under the tax expenditure concept, the income tax system consists of two elements – the structural provisions and the special preference provisions.[100] The structural provisions are the primary rules that exist within a normal income tax system. They are considered necessary to implement a fair and good tax system. Each country has its own unique tax system, and thus the structural provisions of each country may differ. These structural provisions are the benchmark tax. Any tax rules that deviate from this benchmark are tax expenditures. Tax expenditures are the special preference provisions, which give preference only to a certain industry, activity, or class of persons, generally to achieve certain social and economic goals.[101] These provisions are often known as tax incentives or tax subsidies, and can be in the form of exempted income, deductions, deferral of tax liabilities, tax credits or special tax rates.

Therefore, tax expenditures can be defined as tax rules that deviate from the benchmark tax. The first step in tax expenditure analysis is to distinguish between the benchmark element and the tax expenditure element.[102] Surrey pointed out six components of the benchmark: the tax base (that is, the definition of net income), the tax rate, the taxable unit, the taxable period, application to international transactions and tax administration

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[99] Surrey and McDaniel, *Tax Expenditures*, above n 11, 2; Shaviro, above n 87, 201.

[100] Surrey, 'Federal Income Tax Reform', above n 2, 354; Surrey, 'Tax Subsidies as a Device for Implementing Government Policy', above n 11, 197; Surrey, *Pathways to Tax Reform*, above n 3, 6; Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 680; Surrey, 'At Home: Tax Expenditures', above n 11, 53; Surrey, 'Tax Expenditure Analysis: The Concept and Its Uses', above n 12, 4; Surrey and McDaniel, 'Tax Expenditure Concept: Current Developments and Emerging Issues', above n 11, 227-228; Maktouf and Surrey, above n 11, 743; Surrey and McDaniel, *Tax Expenditures*, above n 11, 3.

[101] Surrey, 'Tax Incentives as a Device for Implementing Government Policy', above n 89, 705-706; Surrey, 'Federal Income Tax Reform', above n 2, 353-354; Surrey and McDaniel, 'Tax Expenditure Concept: Current Developments and Emerging Issues', above n 11, 228.

[102] Surrey and McDaniel, *Tax Expenditures*, above n 11, 186.

procedures.[103] These components are discussed below. Since the personal income tax and corporate income tax each has a different nature and some matters relate exclusively to one group, it is more appropriate to have a separate benchmark for each group.[104] This chapter focuses more on the benchmark for corporate income tax to support the objective of this thesis to analyse corporate tax expenditures.

i. The tax base (the definition of net income)

Because income tax is imposed on net income, it is essential to decide the most appropriate way to determine net income. Surrey suggested the Schanz-Haig-Simons (S-H-S) economic concept of income as the appropriate basis.[105] The concept was developed by Georg von Schanz, adopted by Robert Murray Haig and later refined by Henry Simons.[106] Under S-H-S, income is the increase in net economic wealth between two points of time plus consumption during that period. However, the S-H-S income concept covers only basic aspects and discusses only few details, and does not discuss some issues in today's world. Furthermore, items such as self-performed services, gift and bequests, imputed income from personal assets,[107] and the unrealised increases in the value of assets (accrued capital gain), which fall within the definition of income under the S-H-S concept, are traditionally excluded from the definition of income for tax purposes. Therefore, to apply S-H-S income as the tax base, the concept has to be tempered with 'the generally accepted structure of income tax, based on ability to pay'.[108]

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[103] McDaniel and Surrey, *International Aspects of Tax Expenditures*, above n 89, 21-23; Maktouf and Surrey, above n 11, 743.

[104] McDaniel and Surrey, *International Aspects of Tax Expenditures*, above n 89, 21.

[105] Surrey, *Pathways to Tax Reform*, above n 3, 12-13; Surrey, 'Tax Expenditure Analysis: The Concept and Its Uses', above n 12, 3; Surrey and McDaniel, *Tax Expenditures*, above n 11, 186-188; Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 683; Surrey and McDaniel, 'Tax Expenditure Concept: Current Developments and Emerging Issues', above n 11, 228; Maktouf and Surrey, above n 11, 744.

[106] Carl S Shoup, 'The Schanz Concept of Income and the United States Federal Income Tax' (1984) 42(3) *FinanzArchiv* 433, 433-435; Christopher H Hanna, 'Some Observations on a Pure Income Tax system' (2000) 34(1) *The International Lawyer* 125, 125-126; Kevin Holmes, *The Concept of Income: A Multidisciplinary Analysis* (IBFD Doctoral Series, 2001) 55-57.

[107] Imputed income is the value of the benefits that a person receives from the use of his own assets, the services provided to himself and the consumption of self-produced goods/services. The most common example is imputed rent, which is the rental value of owner-occupied property.

[108] Surrey, *Pathways to Tax Reform*, above n 3, 12-13; Surrey, 'Tax Expenditure Analysis: The Concept and Its Uses', above n 12, 4.

More adjustments are required to apply the S-H-S income concept to the corporate income tax. The consumption aspect is irrelevant.[109] Income refers to the increase in net worth of the company, which generally is the difference between total assets and total liabilities in the balance sheet. It can similarly be ascertained by deducting from gross income all expenditure incurred in the production of that gross income, with capital expenditures being allocated over useful life in accordance with accounting principles.[110] Nevertheless, because several accounting principles, such as the matching and prudence principles, do not coincide with tax rules, taxable income cannot be taken straight away from the balance sheet or the income statement.[111]

In practice, it is apparent that S-H-S income is the starting point for most countries' formulation in setting the benchmark tax base, though no country uses it alone in reaching the benchmark in its final form.[112] Rather, they assume it should be the benchmark but then provide a range of rationalisations as to why their national benchmark should deviate (sometimes significantly) from this theoretical model.

ii. The tax rates

There is no normative rate schedule to be adopted as the benchmark.[113] The rate schedules (including a possible zero rate or tax-free threshold for individuals) are determined based on the government's fiscal policy and political goals. Once the benchmark is set, any special rate which is different from the benchmark is regarded as a tax expenditure.[114] Some countries offer a lower tax rate for small and medium-sized businesses. Whether this constitutes a tax expenditure depends on the country's policy and the intention of the government when they first introduced this rate.[115] Usually, if the special rate is given to provide incentives, or to assist certain industries or activities,

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[109] McDaniel and Surrey, *International Aspects of Tax Expenditures*, above n 89, 43.
[110] Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 684.
[111] McDaniel and Surrey, *International Aspects of Tax Expenditures*, above n 89, 43.
[112] Dirk-Jan Kraan, 'Off-budget and Tax Expenditures' (2004) 4(1) *OECD Journal on Budgeting* 121, 131.
[113] Surrey, 'Tax Expenditure Analysis: The Concept and Its Uses', above n 12, 4.
[114] Surrey and McDaniel, *Tax Expenditures*, above n 11, 191-192.
[115] McDaniel and Surrey, *International Aspects of Tax Expenditures*, above n 89, 50.

it should be treated as a tax expenditure. Likewise, a rate higher than the benchmark suggests a negative tax expenditure.

iii. The taxable unit

The determination of the taxable unit is important in the classification of a tax expenditure. In the case of personal income tax, if the individual is chosen as the benchmark tax unit, any tax concessions relevant to the taxpayer's dependants (spouse, children and parents) are considered as tax expenditures.

In the case of corporate income tax, if the tax unit is an individual company, then any intra-group loss set-off is a tax expenditure. The corporate tax unit could also be more specific, for example small and medium enterprises (SMEs) versus large companies, or special tax treatment for special lines of business such as insurance and banking. As a result of these specific tax units, any different tax treatments involving different tax units are considered part of the benchmark and do not give rise to tax expenditures or negative tax expenditures.

The benchmark should also decide on whether a company should be taxed in its own right separately from shareholders, or whether the tax system should be integrated for company and shareholders so that no double taxation is imposed on the same income. The common benchmark is to avoid double taxation. Still, there are many views on how the benchmark should be implemented in this context. They are further discussed below:[116]

(a) *Classical system*. The classical system treats company and shareholders as two separate entities. This means corporate profit is taxed twice, first at company level, and later profit distributed as dividend is taxed at shareholder level. As a

[116] McDaniel and Surrey, *International Aspects of Tax Expenditures*, above n 89, 51-52; George N Carlson, 'International Aspects of Corporate-Shareholder Tax Integration' (1979) 11(3) *Case Western Reserve Journal of International Law* 535, 537-540; R Glenn Hubbard, 'Corporate Tax Integration: A View from the Treasury Department' (1993) 7(1) *Journal of Economic Perspectives* 115, 122-127; Emil M Sunley, 'Corporate Integration: An Economic Perspective' (1992) 47 *Tax Law Review* 621, 624-628.

result of this view, any tax rules that reduce or eliminate tax on dividends at the shareholder level, or allow a deduction for dividends at the company level, are regarded as tax expenditures.

(b) *Full integration system*. On this view company profit is taxed at the shareholder level; the company is actually an aggregate of individual shareholders. All profit, whether distributed or not, is taxed to shareholders at their respective tax rates. To ease tax collection, the company deducts withholding tax and pays net dividends to shareholders. On this view, any relief given to shareholders is a tax expenditure.

(c) *Dividend imputation system*. In a full imputation system, a company pays tax based on the corporate tax rate and dividends are distributed after-tax. Shareholders must include the dividends in their taxable income. The dividends are grossed up (that is, to determine the amount of pre-tax dividends) and taxed to shareholders based on their respective tax rates. To avoid double taxation, shareholders are granted a tax credit for the amount of tax paid by the company. Therefore, effectively it is the shareholders who are required to pay tax on the dividend; the company is merely a collecting agent that withholds the tax that needs to be paid by shareholders. The tax credit is not a tax expenditure because its purpose is to avoid double taxation and not to provide an incentive.

(d) *Dividend exclusion system*.[117] This system is simple to administer, because tax is payable at the company level and distributed to shareholders as exempt income. Tax administration is needed only once. There is no issue of double taxation, and no tax credit is required. Nevertheless, there is no reason to tax the company separately from the shareholders on the basis of ability to pay. The tax paid by the company is actually the prepayment of the shareholders' (that is, the owner's) personal tax liability. Hence, when a dividend is taxed at the

[117] Malaysia appears to accept the view that company tax is a surrogate tax on shareholders and not justifiable as a separate and second tax on the income. In 2008, Malaysia moved from a dividend imputation system to a dividend exclusion system (known as the single-tier system) which led to negative tax expenditures to shareholders with tax rate below 25 per cent. Further discussion on this is set out in Section 6.7.3.

company's tax rate, a negative tax expenditure would arise if the shareholders' tax rate is lower than the company's tax rate, because this would result in the shareholders needing to pay tax more than what they should. Likewise, if the shareholders' tax rate exceeds the company's tax rate (this usually applies only for very high-income group), the shareholders would enjoy tax expenditures.

(e) *Dividend deduction system*. Under this system, dividends distributed to shareholders are regarded as deductible expenses for the company. A company pays tax on profit retained in the company, and shareholders pay tax on profit distributed as dividends. The deduction given to the company is to avoid double taxation; thus it is not a tax expenditure.

iv. The taxable period

Surrey suggested the application of accounting rules as the benchmark tax for several elements that are not covered by the S-H-S income concept, particularly regarding the adoption of accounting period.[118] Tax must be calculated over a specified period. As the S-H-S income concept does not specify the period, the standard practice for taxation follows the accounting practice, to calculate income (and therefore tax) over a period of 12 months. Other elements that relate to the use of accounting period should also be included in the benchmark, such as the allocation of income and expenditure to appropriate periods.[119] Nevertheless, Surrey also pointed out that the use of the standard accounting rules should be tempered 'by resort to practical concerns of tax collection and tax administration'.[120] One example is the issue of deductibility of expenses to be incurred in future years, such as the provision for retirement benefits and provision for warranty services. Based on a company's experience, the retirement benefits and the warranty services are certain to be incurred in future accounting periods. Since they relate to services rendered and sales in the current period, the

[118] Surrey and McDaniel, *Tax Expenditures*, above n 11, 190-191; Surrey, 'Tax Expenditure Analysis: The Concept and Its Uses', above n 12, 3-4; Surrey and McDaniel, 'Tax Expenditure Concept: Current Developments and Emerging Issues', above n 11, 229; Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 683.

[119] McDaniel and Surrey, *International Aspects of Tax Expenditures*, above n 89, 51-52.

[120] Surrey and McDaniel, *Tax Expenditures*, above n 11, 188-190.

matching principle in accounting requires estimates of the amount to be incurred to be set off in the current period's income statement. This practice is not allowed in taxation, due to the concern that the amount recorded as an expense is uncertain and contingent in nature. The tax treatment prefers deductions to be granted only when the actual amount payable is known.[121] Further discussion regarding the deductibility of future expenditure is set out in Section 6.6.

The different treatment in accounting and taxation results in deferral of deductions to a future period, which is a negative tax expenditure. However, if the government takes the view that this deviation is due to the concerns over tax collection and tax administration, then the deviation does not constitute a tax expenditure or negative tax expenditure.[122]

v. The application of the tax to international transactions

There are two main issues related to international transactions. The first is to establish jurisdictional principles that define 'resident' and 'non-resident', because the two groups receive different tax treatment.[123] The second issue is the rule in the case of double taxation when the same income is taxed in two or more countries. It is a norm to allow double tax relief to avoid the same income being taxed twice.[124]

vi. Tax administration

The tax office should have a standard tax administration procedure. The procedure undertaken to administer tax may give rise to a tax expenditure, if there is special treatment for certain taxpayers that deviates from the standard procedure, undertaken

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[121] Courts from different countries have tackled the issues differently. In the decision of the Privy Council (on appeal from the High Court of New Zealand) in the case *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Limited* (1995) 17 NZTC 12,351, the Privy Council ruled that the tax treatment for provision of warranty services should follow the accounting practices. In the US, the Sixth Circuit Court of Appeals in *Chrysler Corp v Commissioner of Internal Revenue* 436 F.3d 644 (2005) refused to give a deduction for anticipated warranty claims on the basis that it is contingent in nature. See discussion on this matter in Section 6.6.1.

[122] Surrey and McDaniel, *Tax Expenditures*, above n 11, 188-190.

[123] McDaniel and Surrey, *International Aspects of Tax Expenditures*, above n 89, 58-59.

[124] Surrey and McDaniel, *Tax Expenditures*, above n 11, 192-193.

with the intention to provide an incentive to taxpayers.[125] For example, certain taxpayers are allowed to pay their taxes over longer periods of time than is generally allowed.[126] If this special treatment results in a lower tax liability, it constitutes a tax expenditure.

3.2.3 Tax Expenditures versus Direct Spending

It is an accepted notion that tax expenditures are ineffective, unfair and unreasonable compared to direct spending.[127] Nevertheless, this is not always accurate. The term 'tax expenditures' should not be treated as a single item; hence, not all of them should be assumed as defective. It is true that most subsidies are better delivered through direct spending; however tax expenditures might have their own advantages. What is necessary is an analysis to decide which of direct spending and a tax expenditure is the better method to achieve the government's intended objectives.[128] Another important point is that tax expenditures should go through a similar process of scrutiny as direct spending to make a fair comparison.[129] This section discusses the arguments that oppose and support the use of tax expenditures.

Opponents of tax expenditures claim that the tax expenditure system is embedded with many limitations, thus making direct spending the favoured method. At the same time, direct spending itself has a better design which renders it superior to tax expenditures. Those arguments are discussed below:

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[125] Surrey and McDaniel, *Tax Expenditures*, above n 11, 193-194.

[126] McDaniel and Surrey, *International Aspects of Tax Expenditures*, above n 89, 61.

[127] Surrey, 'The Congress and The Tax Lobbyist – How Special Tax Provisions Get Enacted', above n 90, 1156; Surrey, 'Federal Income Tax Reform', above n 2, 360; Surrey, 'Tax Incentives as a Device for Implementing Government Policy', above n 89, 720-723.

[128] Surrey, 'Tax Incentives as a Device for Implementing Government Policy', above n 89, 714; Surrey, *Pathways to Tax Reform*, above n 3, 130.

[129] Surrey, 'Tax Incentives as a Device for Implementing Government Policy', above n 89, 715; Surrey, *Pathways to Tax Reform*, above n 3, 130; Kerrie Sadiq, 'The Implementation of Social and Economic Policy through the Tax Regime: A Review of Australia's Tax Expenditures Program' (2008) 23 *Australian Tax Forum* 339, 343-344; Burman and Phaup, above n 96, 25-26.

(i) *Lack of transparency.* The main issue with tax expenditures is they escape the detailed scrutiny put on direct spending programs.[130] Therefore tax expenditures have become hidden government spending, and are commonly used by politicians to pursue their political goals.[131] With less budgetary oversight, less available information, less review and evaluation on their implementation and effectiveness,[132] tax expenditures can easily and quietly slip through the government expenses without much hassle.

(ii) *Benefit the rich / benefit the profitable.* One commonly articulated criticism of tax expenditures that take the form of deductions or exemptions is their "upside down" effect – the benefits are of more value to the rich (subject to higher marginal tax rates) than the poor. Since tax expenditures can only be claimed by those who pay tax, they are often claimed by middle income and high income earners.[133] Low income earners may receive less benefit from tax expenditures, despite the fact that they are the needy groups.[134] Either their income is lower than the tax threshold, or the incentive that they can claim is limited due to low income.[135] On the other hand, the wealthy could get a very low effective tax rate after claiming all tax expenditures they are entitled to.[136] This will not only impair tax fairness, but also upset the objective of the tax expenditures. Direct spending, on the other hand, is channelled directly to the needy groups.

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[130] Surrey, 'Tax Incentives as a Device for Implementing Government Policy', above n 89, 726; Surrey, 'At Home: Tax Expenditures', above n 11, 54; Smith, above n 96, 5-6; Burman and Phaup, above n 96, 25; Kerrie Sadiq, 'An Analysis of Tax Expenditure versus Direct Expenditure', (Paper presented at the Australasian Tax Teachers Association Conference, University of Tasmania, 23-25 January 2008) 12.

[131] Sadiq, 'The Implementation of Social and Economic Policy through the Tax Regime', above n 129, 350.

[132] Donna D Adler, 'The Internal Revenue Code, the Constitution, and the Courts: The Use of Tax Expenditure Analysis in Judicial Decision Making' (1993) 28 *Wake Forest Law Review* 855, 856; Brooks, above n 1, 250.

[133] Donald C Lubick, 'A View from Washington' (1984) 98(2) *Harvard Law Review* 338, 340.

[134] Surrey, 'Tax Incentives as a Device for Implementing Government Policy', above n 89, 720-725; Surrey, 'Tax Subsidies as a Device for Implementing Government Policy', above n 11, 198; Surrey, 'At Home: Tax Expenditures', above n 11, 54; Sadiq, 'The Implementation of Social and Economic Policy through the Tax Regime', above n 129, 349; Burman and Phaup, above n 96, 23.

[135] Surrey, 'Tax Subsidies as a Device for Implementing Government Policy', above n 11, 198; Toder, 'Tax Cuts or Spending – Does it Make a Difference?', above n 95, 366.

[136] Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 698-702; Surrey and McDaniel, 'Tax Expenditure Concept: Current Developments and Emerging Issues', above n 11, 253-254.

The upside-down effect of tax expenditures that take the form of deductions or exemptions is primarily relevant to individuals and the personal income tax system. In terms of the company tax system that is the focus of this thesis, a key characteristic of tax expenditures, be they deductions, exemptions, or non-refundable credits, is the fact that the subsidies do not reach loss-making companies such as start-up companies or enterprises that would shift to commercial operations if they had access to subsidies.

(iii) *Tax expenditures are indefinite and open-ended*. The usual practice for the direct spending budget is to have a ceiling on how much can be spent within a certain budget period. Anything above the ceiling would require a close examination. By contrast, tax expenditures have no set limits.[137] Moreover, if no expiry date was set when they were first enacted, they will remain in the tax system until the government decides that they should be repealed.[138] Thus it is hard to control the flow of funds through tax expenditures.

(iv) *Restrictive accounting period.* The tax system adopts the accounting period as the time interval, which is twelve months. Taxable income and deductions are calculated according to the accounting period. Consequently the design of tax expenditures is restricted to the annual accounting period.[139] Tax expenditures are granted based on one year, and eligibility to receive the incentive is also assessed for a period of one year. In contrast, direct spending can be delivered for a period of less than, or more than, one year, tailored to the recipient's needs.

(v) *Complication of the tax system.* Taxation is already perceived as complicated by the general public. Adding spending programs to the tax system makes it

[137] Burman and Phaup, above n 96, 31; Zhicheng Li Swift, Hana Polackova Brixi and Christian Valenduc, 'Tax Expenditures: General Concept, Measurement and Overview of Country Practices', in Hana Polackova Brixi, Christian M A Valenduc and Zhicheng Li Swift (eds), *Tax Expenditures-Shedding Light on Government Spending through the Tax System* (International Bank for Reconstruction and Development / The World Bank, 2004) 1, 5; Smith, above n 96, 5.

[138] Thomas F Pogue, 'Tax Expenditures: Concept and Framework for Analysis', Office of Tax Policy, New Mexico Taxation and Revenue Department (April 2009) 14.

[139] Toder, 'Tax Cuts or Spending – Does it Make a Difference?', above n 95, 365.

even more difficult.[140] Tax expenditures can take many forms, and there are different criteria to determine entitlement to tax expenditures. Often taxpayers require the help of a tax expert to claim all tax expenditures they are entitled to, particularly for corporate taxpayers. Moreover, because tax expenditures can be used as tax avoidance tools, additional rules need to be introduced to avoid abuse of the incentives. These additional rules add complexity to the tax system.[141] The complexity also causes problems for the tax office staff, since they have more items to audit. As a result, tax expenditures may lead to significant compliance costs for taxpayers and administrative costs for tax collectors.

(vi) *Narrow tax base, high tax rate*. Tax incentives cause the tax base to become narrow which leads to a reduction in the government's revenue.[142] To cover the loss of revenue, the tax rate must be increased. Often the cost must be borne by those who are not entitled to claim tax expenditures.[143] Elimination of tax expenditures should broaden the tax base and reduce the tax rate, and the government would be able to collect the same amount of tax revenue with a simpler tax system.[144]

(vii) *Distortion of economic behaviour*. Tax expenditures upset the principle of neutrality in taxation.[145] They change economic behaviour, sometimes in a way

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[140] Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 707; Surrey, 'Tax Expenditure Analysis: The Concept and Its Uses', above n 12, 8; Surrey and McDaniel, 'Tax Expenditure Concept: Current Developments and Emerging Issues', above n 11, 275-278; Surrey and McDaniel, *Tax Expenditures*, above n 11, 106; Richard Krever, 'Taming Complexity in Australian Tax System' (2003) 25 *Sydney Law Review* 467, 487-488; Sadiq, 'An Analysis of Tax Expenditure versus Direct Expenditure', above n 130, 11.

[141] Toder, 'Tax Cuts or Spending – Does it Make a Difference?', above n 95, 362; Krever, 'Taming Complexity in Australian Tax System', above n 140, 488.

[142] Surrey, 'Tax Incentives as a Device for Implementing Government Policy', above n 89, 725-726; Surrey, *Pathways to Tax Reform*, above n 3, 139-140; Sadiq, 'The Implementation of Social and Economic Policy through the Tax Regime', above n 129, 349; Sadiq, 'An Analysis of Tax Expenditure versus Direct Expenditure', above n 130, 8.

[143] Sadiq, 'The Implementation of Social and Economic Policy through the Tax Regime', above n 129, 356.

[144] OECD, 'Choosing a Broad Base – Low Rate Approach to Taxation', OECD Tax Policy Studies, No 19 (OECD Publishing, 2010) 14-15.

[145] J Clifton Fleming, Jr and Robert J Peroni, 'Reinvigorating Tax Expenditure Analysis and Its International Dimension' (2008) 27 *Virginia Tax Review* 437, 460-461.

that is less desirable and which leads to market distortion.[146] Tax expenditures encourage involvement in particular activities, for example, by giving a tax exemption to companies that operate in that area. This distorts economic choices because tax has become the deciding factor and thus market competition is affected.

(viii) *Administration and monitoring.* Direct spending is administered by specialised government agencies, which have more knowledge in that area than the tax administration.[147] Specialised agencies understand the need of the recipients better than others. If the authority to allocate resources is given to them, they should be able to design a good spending program that can genuinely benefit the recipients. They can also monitor the program continuously for each individual recipient, not only on the eligibility criteria, but also as to how the subsidy was spent and the success of the program. In contrast, tax expenditures are administered by the tax office staff. Eligibility is assessed based on the information provided in the tax return, which is limited. With limited information, monitoring is almost impossible, and the success of the program remains unknown. Nevertheless, there are several tax expenditures that require certification from specialised agencies (most investment incentives in Malaysia require approval from the Malaysian Industrial Development Authority (MIDA)), thus enabling these agencies to provide continuous monitoring.

The opponents of tax expenditures also argue that the claims made as to the benefits of tax expenditures are actually incorrect. These arguments are considered in the following paragraphs:

(i) *Minimisation of cost.* Tax expenditures are said to minimise the financial cost of programs to the government because they are delivered through government's existing agency, the tax office. On the other hand, if an incentive is delivered through direct spending, the government is required to establish a specialised

[146] Surrey, 'Tax Incentives as a Device for Implementing Government Policy', above n 89, 725; Christopher Howard, 'Tax Expenditures', in Lester M Salamon (ed), *The Tools of Government: A Guide to the New Governance* (Oxford University Press, 2002) 410, 432.

[147] Brooks, above n 1, 249.

department, and subsequently incur additional costs. This belief is not always true. The cost to develop a different agency can be kept to a minimum level if the eligibility criteria are as simple as the information provided in income tax return. In any event, the government already has many existing ministries and agencies that can be used to deliver a direct spending program. They are more expert in their area, and should be able to perform work in a more efficient manner (hence at a lower cost) than the tax office staff. There is no need to start a new specialised department.

In addition, direct spending incurs higher costs because it has stricter eligibility criteria, and needs detailed procedures and monitoring. These increase costs, but they are an important process that is normally left out of a tax expenditure program.[148] Although tax expenditures would probably reduce government costs, they lack the detailed scrutiny and supervision present in direct spending. If these are incorporated into the tax expenditure program, the cost should become higher.

Moreover, tax expenditures appear as lower in cost, but actually some costs have been transferred to taxpayers because the filing of a tax return has become more complex.[149] There are also hidden costs incurred by the tax office itself, which include the costs of planning, developing rules, issuing public rulings, collecting tax, tax auditing and dealing with lawsuits by taxpayers.[150]

(ii) *Simple to operate.* Tax expenditures seem to be simple and less complicated to operate as compared to direct spending programs. This could be true; however the complication of direct spending programs run through a government agency also means that the spending has a greater likelihood of being targeted more efficiently. The program is complicated due to the enhanced scrutiny and monitoring process. Although tax expenditures are simple, they have been criticised for benefiting the high income group.

[148] Brooks, above n 1, 246-247.
[149] Smith, above n 96, 21.
[150] Surrey and McDaniel, 'Tax Expenditure Concept: Current Developments and Emerging Issues', above n 11, 280.

(iii) *Encouragement of private sector contribution to government's economic and social programs*. One of the objectives of tax expenditures is to encourage private sector companies to support the government's programs, especially those related to social goals.[151] However, the tax incentive is not always the motivating factor. Tax expenditures alone are not sufficient to attract the private sector's involvement.[152] Other factors could have greater effect such as government regulations and a company's quest to portray a good image to the public as part of their marketing strategy.

Although direct spending is preferred in many cases, such a program itself is not always perfect. If a tax expenditure program is designed properly, it can be better than direct spending. The following observations discuss the potential strengths of tax expenditures:

(i) *Simple, lack of bureaucracy.* Because eligibility to certain tax expenditures is based on information provided in the tax return, the incentive is easier to claim compared to direct spending. This can reduce the opportunity for abuse of power that always arise in direct spending programs, which include giving political favour, discrimination and favouritism, and corruption.[153] Although some argue that stricter control is important for direct spending and tax expenditures,[154] several tax expenditures, especially the general ones, could still be effective despite their simplicity.

(ii) *Improve tax compliance.* Taxpayers are required to claim benefits from the tax office, and in order to claim they must report their income and submit an income tax return. This in turn improves tax compliance, especially for individuals and small business enterprises.

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[151] Surrey, 'Tax Incentives as a Device for Implementing Government Policy', above n 89, 715-716; Surrey, *Pathways to Tax Reform*, above n 3, 131.

[152] Surrey and McDaniel, 'Tax Expenditure Concept: Current Developments and Emerging Issues', above n 11, 290-292; Swift, Brixi and Valenduc, above n 137, 4.

[153] Smith, above n 96, 23.

[154] Surrey, 'Tax Incentives as a Device for Implementing Government Policy', above n 89, 716-718; Surrey, *Pathways to Tax Reform*, above n 3, 131-133.

(iii) *Incentive by way of refundable tax credit.* The features of a tax credit are most similar to direct spending (when compared with other types of tax expenditures).[155] Unlike other types of tax expenditures, a tax credit gives cash reimbursement if the incentive exceeds the tax payable. Therefore, low income taxpayers can still benefit from the incentive. Other types of tax expenditures such as income exemption and tax deduction may not fully benefit these low income earners because when taxable income is already below the minimum tax threshold, they are not required to pay tax but cannot utilise any of the tax incentives.

Despite the claim that both tax expenditures and direct spending could be used to achieve government objectives, outcomes from these two methods might differ, especially with regard to the cost involved.[156] In addition, tax expenditures offer qualitative benefits that cannot be quantified in monetary terms. For example, when the government offers an income tax exemption for participation in a favoured industry that is of national importance, companies in that industry will make an effort to earn profits so that they can benefit from the income tax exemption. In contrast, if the government offers a cash benefit, the companies may not struggle as hard as in the previous case because they know that regardless of their performance, they will still get the subsidy. The process of estimating the cost of tax expenditures cannot include these kinds of costs, as it is not possible to measure them.

3.2.4 Measurement of Tax Expenditures

The issue of measurement of tax expenditures also sparks substantial debate. Measurement of tax expenditures in monetary terms is essential as it represents the amount that would be spent by the government should the incentive be implemented by way of a direct spending program, thus providing information on which among the two

[155] Surrey and McDaniel, 'Tax Expenditure Concept: Current Developments and Emerging Issues', above n 11, 261.

[156] Norman B Ture, 'Tax Expenditures', Statement to the US Senate Committee of Finance, 29 June 1983 <http://iret.org/pub_ture/Ture%20Tmny%201983-Jun%20Sen%20Fin%20Tax%20Expenditures.pdf> 13.

programs is more cost-effective. There are three different measurement methods that can be applied:

(i) *Revenue forgone method*. The most common measurement used is the initial revenue loss method, also known as the revenue forgone method. It measures the estimated reduction in tax revenue that resulted from the introduction of a tax expenditure, with other factors remaining unchanged.[157] According to Surrey, this is the same method used when estimating the revenue loss or gain when any change in tax law is proposed.[158] However, others have criticised the use of this method, claiming that the revenue estimates in the ordinary budget costing processes do not require adjustments for changes in behaviour because they involve a direct outflow of money. On the other hand, failure to account for the effect of any behavioural response and the effect of interaction with other parts of the tax system for tax expenditures is misleading.[159] Tax expenditures do affect taxpayers' behaviour towards certain goods or products. In fact, this is the intention of the government when they introduced a tax expenditure.[160] Similarly, removal of a tax expenditure can change taxpayers' behaviour, as it may increase the use of other tax expenditures. Removal of a tax expenditure can also lead to higher incomes for some taxpayers and push them into higher tax brackets (in the case of a tax system with progressive tax rates). Failure to take these two factors into account can cause inaccurate measurement, and may lead to wrong decision-making by policy-makers. Surrey realised this problem

[157] Kraan, above n 112, 136; Surrey and Hellmuth, above n 3, 535; Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 688.

[158] Surrey and McDaniel, *Tax Expenditures*, above n 11, 6; Surrey and Hellmuth, above n 3, 536; Surrey, 'Tax Expenditure Analysis: The Concept and Its Uses', above n 12, 5; Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 690; Surrey and McDaniel, 'Tax Expenditure Concept: Current Developments and Emerging Issues', above n 11, 238; Maktouf and Surrey, above n 11, 747.

[159] Boris I Bittker, 'Accounting for Federal "Tax Subsidies" in the National Budget' (1969) 22(2) *National Tax Journal* 244, 247; Boris I Bittker, 'The Tax Expenditure Budget – A Reply to Professors Surrey and Hellmuth' (1969) 22(4) *National Tax Journal* 538, 541; Leonard E Burman, 'Is the Tax Expenditure Concept Still Relevant?' (2003) 56(3) *National Tax Journal* 613, 615; Bruce Bartlett, 'The End of Tax Expenditures as We Know Them?' (2001) 92(3) *Tax Notes* 413, 417-418; Roseanne Altshuler and Robert D Dietz, 'Tax Expenditure Estimation and Reporting: A Critical Review' (Working Paper No 14263, National Bureau of Economic Research, August 2008) 23; Norman B Ture, 'Ture's Unreleased Testimony on Tax Expenditures' (1981) 13 *Tax Notes* 1535, 1535; Ture, 'Tax Expenditures', above n 156, 11.

[160] Kraan, above n 112, 137.

but contended that, in seeking a balance between accuracy and reliability, this method is safer and preferred.[161] Besides, imprecise estimates are still better than no estimates at all,[162] in which government could be left without any information about their indirect spending. In addition, similar inaccuracy and lack of information problems exist in the annual direct spending budget; yet it is still highly trusted.[163]

(ii) *Revenue gain method*. The second method, the revenue gain method, is the measure of additional revenue collected by the government if a tax expenditure is repealed.[164] This method is more complicated as it must take into account a taxpayer's behavioural response and the need for a policy specification resulting from the removal of each tax expenditure examined. This method overcomes the criticisms put forward against the first method. However, it is more difficult to apply, and requires additional effort and resources. Moreover, the complexity of the calculation and the inclusion of the behavioural effect, which is hard to measure, make the measurement questionable.

(iii) *Outlay equivalent method*. The third method involves an outlay equivalent estimate, which represents the before-tax cost of a direct spending program designed to have a similar after-tax result to the tax expenditure.[165] Since some direct spending programs are taxable in the hands of the recipient, to make a fair comparison, its measurement as a tax expenditure must be grossed up to show the before-tax result, and the recipient must be as well off after tax as under the existing tax expenditure program.[166] Failing to do so will result in the tax expenditure measurement being understated. Nevertheless, this method is

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[161] Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 690.

[162] Fleming and Peroni, 'Reinvigorating Tax Expenditure Analysis and Its International Dimension', above n 145, 521-522.

[163] Julie Roin, 'Truth in Government: Beyond the Tax Expenditure Budget' (2003) 54 *Hastings Law Journal* 603, 622.

[164] Swift, Brixi and Valenduc, above n 137, 7.

[165] Surrey and McDaniel, *Tax Expenditures*, above n 11, 231.

[166] Seymour Fiekowsky, 'The Relation of Tax Expenditures to the Distribution of the "Fiscal Burden"' (1980, Winter) *Canadian Taxation* 211, 217.

applicable only to tax expenditures where their equivalent direct spending program is taxable.

As a practical matter, the revenue forgone method is widely used. Although some tax experts claim that this method produces inaccurate results, the accuracy of other methods is nevertheless questionable as the calculations are more complex. Thus, the first method is still adopted by many governments in their tax expenditure reporting.[167] The use of the revenue gain method and outlay equivalent method can be found in a few tax expenditure reports, but are available only for selected tax expenditures.[168]

Furthermore, it is also argued that the cost of different tax expenditures should not be added to produce a single total. Since there is interaction between two or more tax expenditures, and also there is interaction between tax expenditures and other parts of the tax system such as the progressive tax rates, adding the estimates could yield double counted and biased estimates.[169] If they are added, the total figure should be accompanied by a note to warn readers about its possible misleading effect.[170] Nevertheless, comparing the annual sum of tax expenditures over a period of time could provide some hints for analysis, since the bias from interaction effects would be less significant in this context.[171]

Ideally, estimates of tax expenditures and direct spending should be comparable. However, to date, this is still not possible due to the difficulties discussed above. Besides, because the measurements are calculated differently, side-by-side comparison could be confusing and misleading. The problem of inaccurate estimates does not rest

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[167] Kraan, above n 157, 137; Christian Valenduc, 'From Tax Expenditure Reporting to Tax Policy Analysis: Some Experience from Belgium' in Hana Polackova Brixi, Christian M A Valenduc and Zhicheng Li Swift (eds), *Tax Expenditures-Shedding Light on Government Spending through the Tax System* (The International Bank for Reconstruction and Development / The World Bank, 2004) 69, 78.

[168] The Australian Tax Expenditures Statement discloses the revenue gain for 10 selected tax expenditures, and the US presents outlay equivalent estimates in the notes.

[169] Altshuler and Dietz, above n 159, 27-28; Fiekowsky, above n 166, 217; Thomas L Hungerford, 'Tax Expenditures: Trends and Critiques' (Congressional Research Service Report for Congress RL33641, Library of Congress, 13 September 2006) 6-7; Ture, 'Ture's Unreleased Testimony on Tax Expenditures', above n 159, 1535; Ture, 'Tax Expenditures', above n 156, 11-12; Bartlett, above n 159, 418.

[170] Surrey, 'Tax Expenditure Analysis: The Concept and Its Uses', above n 12, 5; Kraan, above n 112, 138.

[171] Hungerford, above n 169, 7.

on tax expenditure analysis alone. Direct spending programs and other budget elements also have the same problem. Regardless of the fact that it is very hard to produce accurate estimates of the cost of tax expenditures, it is still an important element in tax expenditure analysis and should in no way be omitted from the report.

3.2.5 Tax Expenditure Reporting

Since the US pioneered the publication of the tax expenditure report (known in the US as the tax expenditure budget) in 1968, many developed countries have followed the same path. Some developing countries also produce tax expenditure reports. This section discusses the importance of tax expenditure reporting, the recommended contents of the report and the steps involved in the preparation of a tax expenditure report, accompanied by brief overviews of reporting practice of four selected countries (the US, Australia, New Zealand and Jordan).

In order to decide what should be included in a tax expenditure report, it is necessary first to determine the objectives or the importance of such report. The objectives should guide a decision as to the contents. The main reason that triggered the development of the tax expenditure concept is when the US government failed to take tax expenditures into consideration when they tried to increase revenue and to cut spending. As such, the tax expenditure report is an important tool to improve efficiency in the government's resource allocation and fiscal policy, and to help government exercise better control over its spending.[172] The report should identify which tax provisions are equivalent to direct spending and hence require detailed scrutiny.[173] It should also include information necessary to further analyse a particular tax expenditure. With the information provided in the report and the analysis on tax expenditures, coupled with existing information from the direct spending budget, the government can see the overall picture of the amount spent to achieve certain goals, the costs and benefits

[172] Surrey and Hellmuth, above n 3, 530; Surrey, 'Tax Expenditure Analysis: The Concept and Its Uses', above n 12, 6-7; Maktouf and Surrey, above n 11, 754.

[173] Eric J Toder, 'Tax Expenditures and Tax Reform: Issues and Analysis' (Paper presented at the National Tax Association Meetings, Miami, Florida, 19 November 2005) 2; Fleming and Peroni, 'Reinvigorating Tax Expenditure Analysis and Its International Dimension', above n 145, 523.

involved and the beneficiaries.[174] The usefulness of the report would be increased if it was presented side-by-side with the direct spending budget; however, due to the problem in measurement as discussed previously, this is currently impossible.

The tax expenditure report is also an important tool to improve the transparency of government.[175] By making the information available to the public, the former 'hidden costs', or 'backdoor spending', are now visible.[176] Hence, the efficiency of tax expenditures, and the tax system as a whole, can be assessed by the public. Not only are tax expenditures able to be viewed as direct spending, they are also subject to the same detailed scrutiny (however, as far as the government is concerned, the extent of this benefit will depend on whether they want to further scrutinise the tax expenditures). This should also prevent the politicians from using tax expenditures to benefit their personal political goals rather than the benefit of the country. The report also benefits the government by disclosing to the public its 'indirect spending', that is, the amount that has been spent through tax expenditures.

There is no standard format in the presentation of a tax expenditure report. The contents and layout of the report vary between countries. The tax base and the method of measurement used to determine tax expenditures are also different, therefore precluding cross-country comparisons. However, these differences are sensible because the report should provide information and data essential to the country's own government and policy-makers.

Still, few guidelines are available as to the information which should be published in a tax expenditure report. The International Monetary Fund (IMF) suggested that a tax expenditure report should display the public policy objective of each tax expenditure, how long it will be effective, to whom the incentive is directed and its estimated costs. The analysis of prior tax expenditures, particularly with regard to how they

[174] Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 692.

[175] Mark Burton, 'Making the Australian Tax Expenditures Statement an Effective Policy Instrument – from Fiscal Report to Transparent Report' (2005) 8(1) *Journal of Australian Taxation* 1, 16-28.

[176] Toder, 'Tax Expenditures and Tax Reform: Issues and Analysis', above n 173, 2.

accomplished the intended objectives, should also be included.[177] Other tax scholars have proposed that a basic tax expenditure report should at least disclose the definition of tax expenditures, the list of the country's tax expenditures and their estimated revenue forgone, and the benchmark tax components used alongside tax rules that have been agreed as the 'generally accepted structure of income tax'. The list of the tax expenditures should be categorised based on the government budget function and the data provided should be for a period of several years, preferably on a basis that is similar to the direct spending budget. Additional information such as the source and duration of the tax expenditures may also be provided.[178]

Most member countries of the Organisation for Economic Co-operation and Development (OECD), which are regarded as the high-income economies, have produced a tax expenditure report of some kind.[179] Several developing countries and emerging economies have produced a report of some kind related to tax expenditures or are working towards it.[180] Any government that wish to implement tax expenditure reporting can do so using the steps below:[181]

(i) *Decide taxes.* The government needs to determine which taxes should subject to tax expenditure analysis. All direct and indirect taxes, including personal income tax, corporate income tax, sales and services taxes, import duty and RPGT can be analysed as tax expenditures. It is preferable for the government to report tax expenditures arising from all types of tax.

(ii) *Elements of benchmark.* If tax expenditures are to be identified using Surrey's conventional approach (i.e. a benchmark is required), the government must first develop the elements of a benchmark tax structure. Different types of tax can have different elements of benchmark.

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[177] IMF Fiscal Affairs Department, *Manual on Fiscal Transparency* (IMF, 2007) 64-65.
[178] Burton and Stewart, above n 4, 14-15.
[179] Kraan, above n 112, 130; Burton and Stewart, above n 4, 32; OECD, *Tax Expenditures in OECD Countries* (OECD Publishing, 2010) 14.
[180] For example India, South Africa, Chile and Brazil. For case studies regarding tax expenditure reporting in these countries, see Burton and Stewart, above n 4, 32.
[181] Based on Maktouf and Surrey, above n 11, 747-752.

(iii) *Identify tax expenditures and negative tax expenditures.* Using the benchmark tax structure, the list of tax expenditures and negative tax expenditures can be produced. To ensure the list is comprehensive, the tax expenditures and negative tax expenditures should be drawn from all sources of tax law, that is, the legislation, judicial decisions and administrative practices.

(iv) *Classification.* To assist in the tax expenditure analysis and to ease the comparison with direct spending, the tax expenditures and negative tax expenditures need to be classified. Several classifications are available, which include by functions or objectives, by ministries, and by beneficiaries.

(v) *Measurement.* One important element in a tax expenditure report is the measurement of the tax expenditures and negative tax expenditures that represent the amount of revenue lost by the government due to that particular tax expenditure. The measurement is an important part of the tax expenditure analysis as it shows how much a particular tax expenditure costs the government. A cost-benefit analysis can be performed to see whether the benefit of the particular tax expenditure outweighs it cost, and whether such cost is acceptable if the tax expenditure is delivered as a direct spending.

(vi) *Publish report.* As part of transparency practice, the tax expenditure report must be published at a regular interval, preferably annually as exercised in the government budget process. The report can be published as an integral part of the government annual budget document. By doing this the tax expenditures are subject to scrutiny every year.

The following paragraphs illustrate tax expenditure reporting in four selected countries. The US is selected because it is the first country to produce a tax expenditure report and include it as part of the annual budget document. Australia has a reader-friendly, comprehensive separate tax expenditure report, and New Zealand is a country that decides not to set any neutral tax benchmark to identify tax expenditure. Jordan represents a developing country that has just started to engage in tax expenditure

reporting; hence this country could be a good example to non-reporting countries, including Malaysia.

i. The United States

The preparation and publication of a tax expenditure report is made mandatory in the US by the Congressional Budget Act of 1974.[182] The definition of tax expenditures under the Budget Act is 'revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of liability'.[183] The tax expenditure report in the US covers only those arising out of income taxes. The US is the only country that produces two sets of tax expenditure reports. One report is produced by the Office of Management and Budget (OMB), a component of the Executive Office of the President of the United States. The second report is prepared by the staff of the Joint Committee on Taxation (JCT), a committee of the US Congress. The Congress prepares a separate tax expenditure report because under the US Constitution, the Congress and the President are two distinct 'coequal branches'.[184] The former represents the legislative branch, while the latter represents the executive branch. These branches offer checks and balances as between each other, to ensure no one branch has excessive power.

The OMB report is published as part of the President's yearly budget, but in a separate section entitled Analytical Perspective.[185] Tax expenditure estimates in this report come from the US Treasury's Office of Tax Analysis.[186] The OMB report provides estimates for a seven-year period – current budget year, two

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[182] Emil Sunley, 'Tax Expenditures in the United States: Experience and Practice' in Hana Polackova Brixi, Christian M A Valenduc and Zhicheng Li Swift (eds), *Tax Expenditures-Shedding Light on Government Spending through the Tax System* (The International Bank for Reconstruction and Development / The World Bank, 2004) 155, 156.

[183] Budget of the US Government, OMB, Executive Office of the President of the US, *Analytical Perspectives* (Fiscal Year 2012) 239; JCT, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014* (JCS-3-10, 15 December 2010) 3.

[184] The White House, *Our Government* <http://www.whitehouse.gov/our-government>.

[185] Budget of the US Government, *Analytical Perspectives* (Fiscal Year 2012), above n 183, 239-276.

[186] OECD, *Tax Expenditures in OECD Countries*, above n 179, 134.

previous years and four future years.[187] Two baseline concepts are used, one is the normal comprehensive income tax baseline, and the other is the reference tax law baseline, both with few adjustments.[188] Items within the reference tax law baseline are also within the normal income tax baseline, but the reverse is not always true. The tax expenditures are measured using the revenue forgone method, and where available, the outlay equivalent estimates are shown in the notes. The present value estimates are disclosed for selected tax expenditures.[189] Also included in the report are brief explanations on how the tax expenditures deviate from the baseline tax system (or in other words, why these tax treatments have been classified as tax expenditures).

The JCT also produces its tax expenditure report annually. The JCT relies on estimates supplied by the Congressional Budget Office.[190] Similar to the OMB report, the JCT report also uses the normal income tax baseline, the S-H-S income concept. However, the JCT uses a broader definition, thus the list of tax expenditures produced is longer. In addition, the JCT includes negative tax expenditures in the report. Estimates are shown for a period of five years – the budget year and four years thereafter – using the revenue forgone method.[191]

ii. Australia

Australia's Treasury produces its Tax Expenditure Statement annually as a separate government document;[192] however, an extract from the statement is included in the federal government's Budget.[193] The statement presents tax expenditure estimates for a seven-year period, consisting of estimates for the current period, three previous years and three forthcoming years. The tax expenditures are classified according to their Budget functions. The current

[187] Budget of the US Government, *Analytical Perspectives* (Fiscal Year 2012), above n 183, 239.
[188] Further discussion on the reference tax law baseline can be found in Section 3.3.
[189] Budget of the US Government, *Analytical Perspectives* (Fiscal Year 2012), above n 183, 239-240; OECD, *Tax Expenditures in OECD Countries*, above n 179, 132-134.
[190] Sunley, 'Tax Expenditures in the United States', above n 182, 168-169.
[191] JCT, *Estimates of Federal Tax Expenditures for Fiscal Years 2010-2014*, above n 183, 24-26.
[192] Australian Treasury, above n 84.
[193] Australian Government, *2011-2012 Australian Government Budget – Budget Paper No 1* (2011) Statement 5: Revenue, Appendix F: Tax Expenditures.

period's tax expenditures are also compared side by side with the direct expenditures. The statement reports tax expenditures arising from various types of taxes including income tax, capital gains tax (CGT), goods and services tax, excise and customs duties, petroleum resource rent tax and other direct and indirect taxes.

The statement defines a tax expenditure as 'a provision of the tax law that provides a benefit to a specified activity or class of taxpayer that is concessional when compared to the "normal" tax treatment that would apply'. Tax expenditure estimates are measured using the revenue forgone method. In addition, estimates using the revenue gain approach are provided for 10 of the largest tax expenditures (ranking based on the revenue forgone method). The tax expenditures from income tax are identified using the S-H-S income concept as the tax base. Other benchmark elements include the application of nominal rather than real income, the use of the cash basis for individuals and accrual basis for businesses, and exclusion of imputed rent from the basis.

Additional information provided in the report includes the tax expenditure types, reliability of tax expenditure measurement, commencement and expiry date of the tax expenditures, their legislative references and brief explanations on how the tax expenditures work.

iii. New Zealand

New Zealand commenced its tax expenditure reporting in 1984, but subsequently it was stopped when the country undertook a major reform of its tax system in which many tax incentives were removed.[194] Recently, commencing in 2010, a tax expenditure statement has been published as part of the annual Budget. The term tax expenditure is defined in the statement as the 'individual features of the tax system that reduce an entity's tax obligation in a way that is designed to give effect to policy other than to raise revenue in the most efficient and economically

[194] Burton and Stewart, above n 4, 29-30.

neutral way'.[195] The statement discloses tax expenditures arising from New Zealand's Income Tax Act and Goods and Services Tax Act. In addition, to improve transparency, appropriated spending through the tax system,[196] which consists of tax credits not identified as tax expenditures, is also disclosed in the statement.

One distinguishing feature of New Zealand's tax expenditure statement is the choice it incorporates to diverge from the common practice of setting the normative tax benchmark.[197] Instead, tax expenditures are identified based on a list of guiding criteria. Those that fulfil all of the following criteria are disclosed in the tax expenditure statement:[198]

1. The concession is available to a targeted group or type of activity;
2. The provision represents a targeted reduction in a tax obligation relative to current tax practice;
3. The provision is not primarily administrative or motivated by a (domestic or international) double taxation objective;
4. The provision is significantly motivated by a non-revenue policy objective.

As a country that has one of the most broadly-based, neutral and efficient tax systems among OECD countries,[199] New Zealand has a short list of tax expenditures. Only 37 tax expenditures from income tax are listed in the tax expenditure statement for both individual and business taxpayers. Nevertheless, the statement also indicates that, as a result of the absence of a benchmark, it is possible that there are further undisclosed tax expenditures.[200] Among the items that would normally be included in a tax expenditure report, but does not appear

[195] New Zealand Treasury, above n 85, 2.
[196] Appropriated spending through the tax system is defined in New Zealand's tax expenditure statement as 'hybrid transfers that can be taken as a cash payment or via a reduction in tax'.
[197] New Zealand Treasury, above n 85, 2.
[198] New Zealand Treasury, above n 85, 3.
[199] Thomas Dalsgaard, 'The Tax System in New Zealand: An Appraisal and Options for Change' (Economics Department Working Papers No 281, OECD, 31 January 2001) 4.
[200] New Zealand Treasury, above n 85, 3.

in the list of New Zealand's tax expenditures, is the tax exemption on capital gains. It should be noted that New Zealand does not have a CGT.

The tax expenditure statement discloses the source of legislation and provides a brief description for each tax expenditure. Of the 37 tax expenditures, only six are presented with tax expenditure estimates for a two-year period – the current year and the forthcoming year.

iv. Jordan

Jordan is in the midst of a tax reform process. Included in this agenda is an attempt by the government to increase tax revenue collection and to improve transparency and accountability by evaluating tax expenditures.[201] The Jordanian government works with Development Alternatives Inc., a consulting agency appointed by the US Agency for International Development to develop a tax expenditure framework and identify tax expenditures from income taxes, sales taxes, custom duty and real property taxes. As this is still at the proposal stage, the report covers mainly the conceptual part of tax expenditures and recommendations for tax reform. The report also produces the list of tax expenditures, but only provides estimates for one year, based on historical data.

The report defines tax expenditures as the deviations from the normal or benchmark tax structure.[202] It provides a separate benchmark tax structure between personal and corporate income taxes. For individuals, the income tax base is gross income reduced by the allowable costs of earning income. For companies, the tax base is the balance sheet methods. Apart from the tax base and tax rate, other features of the benchmark are generally similar for both groups, including that the taxation period follows the calendar year, losses can be carried forward for five years, the use of nominal income instead of real income

[201] Development Alternatives Inc, Report to the United States Agency for International Development, *Evaluating Tax Expenditures in Jordan: Final Report,* Jordan Fiscal Reform II Project, 21 October 2011, 1.

[202] Development Alternatives Inc, above n 201, 3.

and that double tax relief is part of the benchmark.[203] The revenue forgone method is chosen as the measurement for tax expenditure estimates.[204]

Reports from these four countries show that each country produces a unique tax expenditure report based on the information that is needed by the government and policy-makers. Since most of the debates regarding the tax benchmark and tax expenditure measurement originate in the US, the US report seeks to overcome these critiques by employing two baseline concepts – comprehensive income tax and reference tax law, and providing two types of measurement – revenue forgone and outlay equivalent. Unfortunately, too many different methods can cause confusion to readers. The confusion becomes greater when the report is presented in a way that is not reader-friendly.

Perhaps because Australia's Tax Expenditure Statement is produced as a separate report, it gives greater clarity to users. The information is properly arranged and explained. Even though the report uses two methods of measurement, the second method is produced in its own section with adequate elucidation to clarify all concerns regarding this method. The brief information about tax expenditures assists first-time users to understand the concept. Nevertheless, the report's attempt to calculate the aggregate tax expenditures by their functional category and later to compare them with their counterparts from direct spending could cause misunderstanding and misinterpretation. Although readers are warned in advance about the possible mix-up, the data has no informative value and could better be discontinued in the future.

New Zealand's tax expenditure statement is short and brief, because it has a small number of tax expenditures and does not reveal much information regarding identified tax expenditures. Apart from the absence of a benchmark, the statement does not disclose the method of measurement chosen, the non-revenue policy objective, the targeted group and the duration the incentives are effective.

[203] Development Alternatives Inc, above n 201, 5.
[204] Development Alternatives Inc, above n 201, 21.

Jordan's first tax expenditure report, even though very brief and not containing adequate information, is an excellent effort towards a more comprehensive process in the future. The most fundamental issue in identifying tax expenditures, the benchmark tax base, has been specified in this report. The Jordanian government should now put greater effort into producing a tax expenditure report annually, and to providing tax expenditure estimates and projections for several years.

Comparing the above tax expenditure reports, as well as reports from other countries,[205] most reporting countries have similar basic features. Most countries have adopted the revenue forgone method as the method of measuring tax expenditures, with only the US offering the outlay equivalent method as an additional measurement disclosed in notes, and Australia offering the revenue gain method for selected tax expenditures. Also, most countries use an income tax benchmark, although in the academic debate many tax and economic scholars favour the use of a consumption tax benchmark. Yet, cross-country comparability is still impossible due to distinct specific features in the chosen benchmark, except for some limited comparisons. These include treatment for depreciation, double taxation of corporate dividends and other variations rooted in the distinct tax system of each country.[206]

3.3 THE DEBATE ON THE MOST APPROPRIATE TAX BASE

Since its introduction, tax expenditure analysis has received various criticisms. The earliest criticism was from Professor Bittker of Yale Law School. Bittker criticised the ambiguities within the analysis, and the effect of personal judgment in relation to the concept.[207] Subsequent critics of the tax expenditure concept have always quoted his comments. Some criticise the whole concept, claiming it to be misleading, ambiguous,

[205] Based on the work by the OECD in *Tax Expenditures in OECD Countries*, above n 179, and a publication by the World Bank in Swift, Brixi and Valenduc, above n 137, 1.

[206] OECD, *Tax Expenditures in OECD Countries*, above n 179, 70-72.

[207] Bittker, 'Accounting for Federal "Tax Subsidies" in the National Budget', above n 159, 244-261; Bittker, 'The Tax Expenditure Budget', above n 159, 538-542.

deeply flawed and confusing, and to be far from achieving its original objectives.[208] Others have proposed a new paradigm in which to view tax expenditures.[209] Critics come not only from the community of tax scholars but also from within the government. At one time, the US government under the administration of then newly-elected President George W Bush made the charge that the 'tax expenditure is of questionable analytic value'.[210]

However, the issue that attracts most criticism is the tax base. Deciding upon the most appropriate concept of income to be adopted as the tax base is fundamental in tax expenditure analysis. The choice of the tax base affects what should and should not be included in the list of tax expenditures. In fact, the discussion about the most appropriate tax base for a country's tax system started decades earlier. Unsurprisingly, there was substantial debate regarding this subject when the concept of tax expenditures was first introduced, dominated by tax scholars and tax experts from the US. The debate continues to the present. Surrey's choice of tax base, the S-H-S income concept (modified to include the generally accepted structure of income tax and business accounting practice)[211] was heavily criticised; however, other proposed alternatives have received an equal (if not greater) level of criticism.

In general, there are two sets of debates. The first is the debate about the tax base for a country's tax system; hence affecting the tax base for tax expenditure analysis. The second debate relates to the basis for analysing tax expenditures (not the tax system as a whole). The following paragraphs of this section review these debates.

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[208] For further readings on this issue see Bittker, 'Accounting for Federal "Tax Subsidies" in the National Budget' above n 159; Bittker, 'The Tax Expenditure Budget' above n 159; Ture, 'Ture's Unreleased Testimony on Tax Expenditures', above n 159, 1537; Ture, 'Tax Expenditures', above n 156; Bartlett, above n 159; Douglas A Kahn and Jeffrey S Lehman, 'Tax Expenditure Budgets: A Critical View' (1992) 54 *Tax Notes* 1661, Burman, 'Is the Tax Expenditure Concept Still Relevant?' above n 159,613.

[209] David Weisbach and Jacob Nussim, in 'The Integration of Tax and Spending Programs' (2004) 113(5) *The Yale Law Journal* 955, proposed a new paradigm where the concept of tax expenditures is viewed as a problem of institutional design and not a tax policy issue.

[210] Budget of the US Government, OMB, Executive Office of the President of the US, *Analytical Perspectives* (Fiscal Year 2002) 61.

[211] Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 683; Surrey and McDaniel, *Tax Expenditures*, above n 11, 188-189.

The S-H-S concept of income, which is also referred to as the comprehensive income tax, is commonly used as the base for income tax in countries such as Australia and the US. It is common practice to exclude certain forms of income described under this concept from the income tax, such as imputed rent, imputable labour income and unrealised capital gains. Nevertheless, some scholars argue that the exclusions are actually tax preferences that can be enjoyed only by those who have such income, hence being unfair to those who do not.[212]

Since the early stages of adoption of the income tax, some economic scholars have proposed that the government adopt the consumption tax rather than the income tax.[213] A consumption tax taxes people on what they spend, not what they earn. As such, savings are not taxable under a consumption tax (as opposed to S-H-S income taxation that imposes tax on income which is saved). In reality, most current tax systems are hybrid systems that have both income tax and consumption tax elements embedded in them.[214] For example, savings in retirement funds generally are not taxable until they are withdrawn. Another example is the capital gain, which is not taxable unless it has been realised (under the S-H-S rule capital appreciation would be taxed even though the asset has not been sold). Nevertheless, some experts argue that the inclusion of consumption elements in the tax system is for administrative necessity and practicability, and therefore should not be viewed as giving rise to a hybrid system.[215] When S-H-S income was chosen as the tax base in tax expenditure analysis, the proponents of the consumption tax viewed this as an impediment to their effort to move

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[212] Boris I Bittker, 'A "Comprehensive Tax Base" as a Goal of Income Tax Reform' (1967) 80(5) *Harvard Law Review* 925, 981-982; John Bossons, 'The Value of a Comprehensive Tax Base as a Tax Reform Goal' (1970) 13(2) *Journal of Law and Economics* 327, 343.

[213] See Walter A Morton, 'A Progressive Consumption Tax' (1951, June) 4(2) *National Tax Journal* 160; Richard Goode, 'Income, Consumption and Property as Bases for Taxation' (1962) 52(2) *American Economic Review* 327; Nicholas Kaldor, *An Expenditure Tax* (George Allen and Unwin, 1955).

[214] Edward J McCaffery, 'Tax Policy Under a Hybrid Income-Consumption Tax' (1992) 70 *Texas Law Review* 1145, 1152-1155; Linda Sugin, 'Tax Expenditure Analysis and Constitutional Decisions' (1999) 50 *Hastings Law Journal* 407, 427; Toder, 'Tax Expenditures and Tax Reform: Issues and Analysis', above n 173, 6; Robert Carroll, David Joulfaian and James Mackie, 'Income versus Consumption Tax Baselines for Tax Expenditures' (2011) 64(2, Part 2) *National Tax Journal* 491, 493.

[215] Fleming and Peroni, 'Reinvigorating Tax Expenditure Analysis and Its International Dimension', above n 145, 514-515.

to consumption taxation, since the consumption elements in the tax system are normally identified as tax expenditures.[216]

A group of researchers has examined the use of the 'X tax', a new breed of consumption tax, as the tax base to identify and measure tax expenditures.[217] The X tax was developed by David F Bradford as a proposal for US tax reform. It has the feature of a consumption tax of promoting investment and savings, but also incorporates a structure similar to the current income tax system.[218] The X tax offers separate rules for business tax and individual tax. Business tax is applicable to all forms of businesses (company, partnership and sole proprietorship), where they are taxed at one single rate. Individual tax, also referred to by Bradford as compensation tax, uses progressive tax rates, with the maximum rate equal to the business tax rate. It also supports the notion that all income should be taxed only once, either in the hands of the contributor or in the hand of the recipient. Nevertheless, like other applied and proposed tax expenditure bases, it has its own ambiguities and shortfalls, and has several alternative treatments based on various factors within the consumption tax itself.[219]

There is also debate regarding the basis or method to be used to analyse tax expenditures. Most of the disputes involve disagreement with Surrey's concept that requires setting of the tax base to identify and analyse tax expenditures. Professor Michael McIntyre, who argued that Surrey's definition of tax expenditure was problematic, asserted that the list of tax expenditures produced by Surrey and his team in the US Treasury has 'no serious claim of legitimacy'.[220] He proposed a new approach that ignores the need to identify a normal tax structure. McIntyre's approach is to examine the purpose of each tax rule. If its purpose is to promote a spending goal,

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[216] J Clifton Fleming, Jr and Robert J Peroni, 'Can Tax Expenditure Analysis be Divorced from a Normative Tax Base?: A Critique of the "New Paradigm" and Its Denouement' (2010) 30(1) *Virginia Tax Review* 135, 141.

[217] Carroll, Joulfaian and Mackie, above n 214, 498.

[218] For more details about the X tax system, see David F Bradford, *Untangling the Income Tax* (Harvard University Press, 1986) and David F Bradford, *The X Tax in the World Economy: Going Global with a Simple, Progressive Tax* (AEI Press, 2004).

[219] Carroll, Joulfaian and Mackie, above n 214, 508-509.

[220] Michael J McIntyre, 'A Solution to the Problem of Defining a Tax Expenditure' (1980) 14 *University of California Davis Law Review* 79, 80-81.

then it is a tax expenditure and should be subject to tax expenditure analysis.[221] Although this approach may have overcome the critiques on Surrey's choice of base, it sparks a different problem. It is difficult to determine the purpose of a tax rule. The proponents of the tax incentives might have changed their language, averting the conclusion that a spending goal is involved, and instead defend their arguments using other goals that do not give rise to a tax expenditure.[222] As a result, many tax expenditures could easily escape detailed scrutiny.

One proposal which led to a short-term change was made by Seymour Fiekowsky, who, at the time he published his important article in this field in 1980,[223] was Assistant Director of the Office of Tax Analysis, US Treasury Department. He argued that the tax expenditure budget produced by the US Treasury was fundamentally erroneous because it failed to distinguish tax rules that serve to achieve objectives of spending programs from those rules that are related to the basic structure of tax law.[224] According to Fiekowsky, only a tax incentive that is inconsistent with the basic structure of the tax law, and can be substituted for by a direct spending program, should be classified as a tax expenditure. Fiekowsky claimed that some tax rules such as accelerated depreciation or capital gains preferences had no spending objectives and could not be replaced with direct spending programs. He claimed, consequently, that they were not tax expenditures but rather reflected a tax policy or structural issue.[225] For a brief period of two years, the US Treasury adopted Fiekowsky's proposal, named as the 'reference tax law' baseline, and discontinued Surrey's S-H-S baseline, in its tax expenditure budget prepared for fiscal years 1983 and 1984.[226] The reference tax law baseline identifies as tax expenditures those 'special exceptions from a generally provided tax rule that serve programmatic functions in a way that is analogous to spending programs'.[227] Generally, reference tax law is similar to tax law in application. General tax provisions that have no spending objectives, such as accelerated capital

[221] McIntyre, above n 220, 100.
[222] Fleming and Peroni, 'Can Tax Expenditure Analysis be Divorced from a Normative Tax Base?', above n 216, 149-150.
[223] Fiekowsky, above n 166.
[224] Fiekowsky, above n 166, 213.
[225] Fiekowsky, above n 166, 215.
[226] JCT, *A Reconsideration of Tax Expenditure Analysis* (JCX-37-08, 12 May 2008) 26.
[227] Budget of the US Government, *Analytical Perspectives* (Fiscal Year 2012), above n 183, 240.

allowances, are not considered as tax expenditures. Thus the reference tax law baseline generates fewer tax expenditures than the S-H-S baseline.[228] However, since 1985, the US Treasury has returned to the S-H-S baseline but offers reference tax law as an alternative baseline.[229]

Victor Thuronyi claimed that Fiekowsky's proposal adopted by the US Treasury is deficient, as it fails to clarify the approach needed should a tax provision have multiple purposes.[230] Thuronyi's proposed method is actually an expansion of Fiekowsky's suggestion and requires identification of tax provisions that can be substituted for by non-tax programs.[231] These 'substitutable tax provisions' are classified by identifying the significant purposes of a tax provision, and possible non-tax programs that can effectively achieve the same purposes are identified. This part of the process is similar to Fiekowsky's approach. Thuronyi refined the idea by explaining the approach that should be taken if a tax provision has more than one purpose, and these purposes can be achieved by both the tax system and a non-tax program. He proposed the use of judgment, to evaluate the advantages and disadvantages of the tax provision and its non-tax substitutes. However, this refinement is already part of tax expenditure analysis proposed by Surrey, which requires a tax expenditure with a justified objective to be subject to cost-benefit analysis to determine the best method that can achieve that objective.[232]

In 2008, the US JCT proposed a 'new paradigm' approach to its tax expenditure analysis to overcome the criticisms over the use of the normal tax base.[233] The new paradigm divides tax rules into two categories. The first is 'Tax Subsidies', where a tax subsidy is defined as 'a tax provision that is deliberately inconsistent with an identifiable general rule of the present tax law… and that collects less revenue than the general tax rule'. This category basically refers to Fiekowsky's approach which specifies that a tax expenditure must be inconsistent with the basic structure of the tax

[228] Budget of the US Government, *Analytical Perspectives* (Fiscal Year 2012), above n 183, 240, 255-256.
[229] JCT, *A Reconsideration of Tax Expenditure Analysis,* above n 226, 26.
[230] Victor Thuronyi, 'Tax Expenditures: A Reassessment' (1988) 1988 *Duke Law Journal* 1155, 1186.
[231] Thuronyi, above n 230, 1186-1188.
[232] Fleming and Peroni, 'Can Tax Expenditure Analysis be Divorced from a Normative Tax Base?', above n 216, 152, fn 71.
[233] JCT, *A Reconsideration of Tax Expenditure Analysis,* above n 226, 39-42.

law,[234] and is consistent with the US Treasury's reference tax law baseline. The second category, 'Tax-Induced Structural Distortions', represents structural elements within the tax law that 'materially affect economic decisions in a manner that imposes substantial efficiency costs'. Interestingly, in its tax expenditure estimates for fiscal year 2009-2013, the Joint Committee reverted to the normal income tax baseline approach. The Committee asserted that, practically, the application of either the new paradigm or the normal tax base approach will generate a similar list of tax expenditures, although the list produced by the normal tax base approach is more expansive.[235]

Most of these debates have taken place in the US; hence this explains why tax expenditure reports in the US offer different baselines and different measurements. Looking at the practical side, these arguments have had minimal influence on tax expenditure reporting in other countries (apart from the US). Every country that prepares a tax expenditure report has its own unique definition of the benchmark income tax base.[236] Many countries do not have a specific definition; rather, they use a list of criteria to describe what should be included in the benchmark. Other countries, including Canada, Japan, France, Germany, Korea, the Netherlands, Spain and the UK, describe their benchmark without referring to any specific theory.[237] All reporting countries use income tax as the tax base except for tax expenditures from consumption taxes such as value added tax and goods and services tax. Although many accept the S-H-S income concept as the base, the income tax benchmark for each country still differs to follow the country's own unique tax system, and this hinders cross-country comparability. Regardless of which tax base is chosen, the ultimate rule that tax should be imposed on the basis of fairness and ability-to-pay should always become the priority.

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[234] Fiekowsky, above n 166, 215.

[235] JCT, *Estimates of Federal Tax Expenditures for Fiscal Years 2009-2013* (JCS-1-10, 11 January 2010) 4-5.

[236] OECD, *Tax Expenditures in OECD Countries*, above n 179, 151-153; Christopher Heady, 'Tax Expenditures: Definitional and Policy Issues', in Lisa Philipps, Neil Brooks and Jinyan Li (eds), *Tax Expenditures: State of the Art* (Canadian Tax Foundation, 2011) 2:1, 2:4.

[237] OECD, *Tax Expenditures in OECD Countries*, above n 179, 76-140.

3.4 ACCOUNTING STANDARDS AS AN ALTERNATIVE BENCHMARK FOR CORPORATE TAX EXPENDITURES

An income tax is a tax on chargeable income, and the first step to arriving at chargeable income is to determine adjusted income. Adjusted income is derived by deducting from gross income all expenses and costs incurred to earn the gross income.[238] This is the requirement by Malaysia's ITA 1967 section 33(1), which states that:

> Subject to this Act, the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person from that source for that period all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of gross income from that source, including...

In accounting, the term profit is defined as 'the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income'.[239] Literally, adjusted income for taxation purposes does not significantly differ from accounting profit. They are both the result of income minus expenses. Yet, in almost all cases, accounting profit must be adjusted to arrive at taxable income. Section 33(1) of the ITA 1967 opens with the phrase '[s]ubject to this Act', which means that income is calculated not only by deducting all outgoings and expenses incurred, but must also take into account all other provisions in the Act. The following paragraphs briefly discuss issues related to these two similar but different terms, and later argue why accounting standards could be a workable benchmark for corporate tax expenditure analysis.

The effort to promote accounting standards as the base in the calculation of corporate income tax is not new. It started many years ago, advocated mainly by the accounting community, but sometimes receiving support from the legal community.[240] The

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[238] Surrey, 'Tax Incentives as a Device for Implementing Government Policy', above n 89, 724; Surrey, *Pathways to Tax Reform*, above n 3, 138.

[239] IFRS Foundation, *The Conceptual Framework for Financial Reporting* (November 2011), para 4.60.

[240] See for example Kenneth L Wertz, 'A Book Income Tax: First Order Computations' (Proceedings of the 91st Annual Conference on Taxation, Austin, Texas, 8-10 November 1998) 314; Harold Dubroff, M

accounting community argues that, since accounting income is convincing enough for investors and creditors, it should also be convincing enough for tax assessment. Furthermore, the use of accounting income for tax purposes could simplify the tax system and minimise compliance costs, therefore reducing tax avoidance.[241] As is to be expected, there are many dissenting views, most coming from experts in economics and law.[242] There are various reasons for this, which include the different objectives between accounting and taxation, and the issue of timing and uncertainties in accounting provisions. There is also concern about the role of the accounting standard setters, the IFRS, which is a private organisation, playing the government role of determining what should and should not be taxed.

During the process of development by the European Union (EU) of the Common Consolidated Corporate Tax Base (CCCTB) to be applied in all EU Member States, the use of international accounting standards has been seriously considered.[243] Many have proposed that accounting standards are suitable as the starting point, but require further adjustments and clarifications.[244] This proposal requires EU Member States to harmonise both tax and financial accounting rules; this may involve many obstacles since there are various different tax and accounting systems among the Member States.

Connie Cahill and Michael D Norris, 'Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles' (1983) 47 *Albany Law Review* 354; Aldrin De Zilva, 'The Alignment of Tax and Financial Accounting Rules: The Case for a New Set of Common Rules' (2005) 1(1) *Journal of the Australasian Tax Teachers Association* 66; Kevin Holmes, 'Should Accountants Determine How Much Tax We Pay?: International Accounting Standards vs Taxable Income and Capital Gains' (2008) 14(3) *New Zealand Journal of Taxation Law and Policy* 316.

[241] Holmes, 'Should Accountants Determine How Much Tax We Pay?', above n 240, 325.

[242] See for example Calvin Johnson, 'GAAP Tax' (1999) 83 *Tax Notes* 425; Howard M Weinman, 'Conformity of Tax and Accounting' (1981) 59(7) *Taxes-The Tax Magazine* 419; Judith Freedman, 'Aligning Taxable Profits and Accounting Profits' (2004) 2(1) *eJournal of Tax Research* 71; Judith Freedman, 'Financial and Tax Accounting: Transparency and "Truth"' (Legal Studies Research Paper Series Working Paper No 02/2008, Faculty of Law, University of Oxford, 2008).

[243] European Commission Taxation and Customs Union, *Common Tax Base* <http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm>. EU membership consists of 27 countries and each country has its own tax system. The CCCTB, a single set of tax rules to be used in the calculation of corporate taxable income for all 27 Members, is considered a systematic way to overcome the current problem of companies operating in more than one EU country.

[244] Wolfgang Schön, 'International Accounting Standards – A "Starting Point" for a Common European Tax Base?' [2004] (October) *European Taxation* 426; Clemens Fuest, 'The European Commission's Proposal for a Common Consolidated Corporate Tax Base' (2008) 24(4) *Oxford Review of Economic Policy* 720; Judith Freedman and Graeme Macdonald, 'The Tax Base for CCCTB: The Role of Principles' (Oxford University Centre for Business Taxation Working Paper No 08/07, 2008).

The requirement to harmonise financial accounting rules was finally removed. Member States can continue to use their national financial accounting rules, and are required to harmonise the calculation of tax base only.

Belgium has successfully used accounting standards as its tax expenditure benchmark.[245] Accounting profit is considered as taxable profit, but as in the case where economic income is the benchmark, the two profit amounts do not always match, due to the availability of various tax incentives and non-deductibility of certain expenses for tax purposes.

The above discussion shows that accounting income has been viewed by many scholars to have a close relationship with taxable income. This study proposes the use of accounting standards as an alternative benchmark for the corporate income tax base in tax expenditure analysis. Since individual income differs from corporate income, and the calculation of individual taxable income differs from the calculation of corporate taxable income, it is worthwhile to consider a different benchmark for the corporate income tax. Accounting income calculated on the basis of approved accounting standards is a reasonable and workable benchmark, for the reasons set out below:

(i) '*Off the shelf*' *benchmark*. Tax expenditure reports may potentially be even more important in non-OECD economies in which the revenue costs and economic distortions from a proliferation of tax concessions may be substantial. Malaysia is among many countries that have not yet begun to publish a tax expenditure report. Realising the importance of such a report, it is a priority for Malaysia to start the process as soon as possible. The choice of benchmark is a fundamental issue in the preparation of tax expenditure reports. The political considerations that have influenced the development of *ad hoc* benchmarks for tax expenditure reports in OECD economies leave each slightly different and, arguably, only suited for the jurisdiction for which it was created. This raises the question of how other economies should go about adopting a tax benchmark for identifying tax expenditures.

[245] Valenduc, above n 167, 77.

There are endless debates among Western scholars about the most appropriate benchmark. This study suggests it is not necessary for emerging economies to emulate the experience of OECD countries and devote considerable efforts to creation of customised benchmarks affected by political considerations. After all, those debates have taken place after the adoption of a tax expenditure report and an analysis of it. In this context, it may be sensible to move away from them and use an 'off the shelf', readily available benchmark, in the form of national accounting standards (or international standards where they have been adopted for national use). With only a small number of adjustments needed for areas where tax law could deviate from accounting principles to achieve necessary anti-avoidance objectives, such as countering transfer pricing or income splitting, accounting standards can provide a neutral and fair benchmark. The use of a ready-made and already known and understood benchmark can accelerate significantly the process of adopting tax expenditure reports in non-OECD countries.

Of course it might be suggested that introducing accounting standards as the benchmark does not solve the tax base debate but rather adds to the debate. It could be argued that it would be most efficient to use S-H-S income (the starting point for almost all national benchmarks) as the benchmark and simply avoid the multiple deviations from that base that make their way into the national benchmarks. In a sense, however, this is what is being proposed in this thesis. With one exception, accounting income and S-H-S income largely overlap.[246] Under both concepts, income is the increase in wealth, or to put it in accounting language, the increase in net assets (assets minus liabilities). The main difference between accounting and S-H-S concepts of income involves the treatment of unrealised capital gains. Accounting standards recognise most types of capital gains at the point of realisation while S-H-S recognises accruing gains on an annual basis. With this exception, adoption of accounting standards

[246] Holmes, 'Should Accountants Determine How Much Tax We Pay?', above n 240, 319.

as the tax benchmark in effect is the same as using S-H-S income as the benchmark.

(ii) *Most tax expenditures are unambiguous.* Regardless of the choice of benchmark, the vast majority of tax expenditures fall into areas that are not controversial. Tax treatments such as accelerated depreciation and double deductions are undeniably tax expenditures under every benchmark. The never-ending benchmark argument relates to issues that sit on the edge of the concept, and affect only a small percentage of tax expenditures, such as the taxability of unrealised capital gains. No single benchmark can satisfy all of the parties involved; therefore the proposal to use accounting standards as the tax base may at least convince some of them.

(iii) *IFRSs are internationally recognised.* IFRSs have been (and will continue to be) adopted by most countries around the world. Accounting profit as it appears in audited financial statements has been accepted worldwide as a reasonable and reliable measure of a company's performance.[247] It is a practical and realistic way to calculate corporate income, unlike some theories of income that are impractical and need adjustments and assumptions before they can be applied in the real world. Besides, the use of accounting standards as the benchmark would promote harmonisation of tax expenditure reports, thus facilitating comparisons among reports from different countries. Currently, data on tax expenditures is not comparable between countries since each country uses a different tax benchmark. Furthermore, accounting standards use objective measurements to calculate the business profits for the period, which means that their preparation is supported by evidence and not influenced by subjective valuations and bias.[248] Accounting standards are designed to provide relevant information to assist users in making decisions.[249] The information which is

[247] Lili-Anne Kihn, 'Comparing Performance Measurement Approaches in Accounting Research' (2005) 2 *Finnish Journal of Business Economics* 143, 145; John J. Wild *et al*, *Financial Accounting: Information for Decisions* (McGraw Hill Education, 2nd ed, 2014), 565-566.

[248] Joel G Siegel and Jae K Shim, *Accounting Handbook* (Barron's Educational Series, Inc, 4th ed, 2006), 575; Holmes, 'Should Accountants Determine How Much Tax We Pay?', above n 240, 326.

[249] IFRS Foundation, *The Conceptual Framework for Financial Reporting*, above n 239, para QC1.

disclosed must also be complete, neutral and free from material error.[250] In addition, because accounting standards are regularly reviewed, they offer a contemporary approach to reflect the most recent changes in a business environment that has become more complex. The process of developing accounting standards involves detailed and thorough procedures to ensure that the financial statements which are prepared reflect a company's true performance. The government should take advantage of these detailed procedures. At the same time, companies can benefit from the reduction in compliance costs, as most financial statement information can also be used for tax purposes.[251]

(iv) *Taxable income is unique.* Neither economic income nor accounting income can fit taxable income perfectly.[252] The S-H-S income concept requires modifications to certain parts before it can be adopted as the benchmark. Likewise, accounting and taxation have different underlying principles.[253] Thus, income calculated based on accounting standards must be adjusted before it can be applied as the tax benchmark. Treatments that can affect tax collections and tax administration procedures, or that are parts of anti-tax avoidance measures, may need to be added as part of the benchmark if accounting income is used. Since the accounting concept of income is narrower than the economic concept of income,[254] it requires fewer modifications, as the adjustments required by the S-H-S income concept mentioned earlier, such as the exclusion of self-performed services and unrealised capital gain from the definition of income, are already incorporated in accounting rules. Hence, it is difficult to conclude which concept of income is more appropriate. However, the practicability of accounting income to measure company's profits suggests that accounting standards are a workable benchmark.

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[250] IFRS Foundation, *The Conceptual Framework for Financial Reporting*, above n 239, para QC12.
[251] Kevin Holmes, 'Should Accountants Determine How Much Tax We Pay?', above n 240, 325.
[252] Burman, 'Is the Tax Expenditure Concept Still Relevant?' above n 159, 619; Ture, 'Ture's Unreleased Testimony on Tax Expenditures', above n 159, 1537; Ture, 'Tax Expenditures', above n 156, 3-4; .
[253] Freedman, 'Financial and Tax Accounting', above n 242, 10.
[254] Holmes, 'Should Accountants Determine How Much Tax We Pay?', above n 240, 324.

(v) *A company is a separate legal entity*. Under the S-H-S concept, a company is not a taxable entity. Rather, the income of the company is taxable to its shareholders, and the company only acts as a collecting agent on behalf of the shareholders.[255] Surrey disagreed with this view. He recognised companies as taxable entities, reflecting in part the US bias in his view. This view also contradicts the concept of legal personality in company law. Generally, under company or corporate law, a company is a legal artificial person – it can sue and be sued, incur liabilities, own assets – and hence be taxed.[256] This is similar to the concept of separate legal entity in accounting.

(vi) *Accounting profit satisfies the ability-to-pay principle*. Profit represents the increase in purchasing power of an entity, and therefore represents the entity's ability-to-pay.[257] The income statement is used to evaluate the company's ability to generate cash and cash equivalents in the future.[258] Information provided in financial statements is utilised by shareholders to determine the company's ability to pay dividends, is trusted by creditors to evaluate the company's ability to pay debts, and is used by employees to assess the company's ability to pay wages, and hence should provide sufficient information to measure the company's ability to pay taxes.

3.5 SOURCES OF DIFFERENCES BETWEEN ACCOUNTING INCOME AND TAXABLE INCOME

As mentioned above, taxable income is unique, and accounting income could not perfectly fit taxable income. Although there have been various attempts to harmonise these two concepts of income, complete harmonisation is almost impossible. The courts often note that the method of keeping accounts offers a guide to interpretation of

[255] Musgrave, above n 94, 336.
[256] *Companies Act 1965* (Malaysia), s 16(5).
[257] Wolfgang Schön, 'The Odd Couple: A Common Future for Financial and Tax Accounting?' (2005) 58 *Tax Law Review* 111, 129; IFRS Foundation, *The Conceptual Framework for Financial Reporting*, above n 239, para 4.63.
[258] IFRS Foundation, *The Conceptual Framework for Financial Reporting*, above n 239, para 4.27.

the tax law but is never conclusive in tax issues.[259] As tax rules differ between countries, it is not feasible for accounting to follow tax rules. The reasons why accounting income and taxable income cannot be aligned are discussed below:

(i) *Different objectives and purposes.* Accounting and taxation have different objectives; therefore they need to be designed differently. Financial statements are prepared mainly to show a company's financial performance and position to shareholders, potential investors and creditors.[260] Generally what such parties need to know is the current and future performance of the company; whether the company is sufficiently stable to give a high return on investment and pay its debts.[261] Thus accounting standards are designed to provide trusted and reliable information about the company's performance, which would also be used to protect investors and creditors from fraud on the part of the company. In marked contrast to the objective of accounting, tax is a source of revenue for the government. Tax revenue is used to fund government expenditure; more taxes need to be raised if spending is high. Government has the right to tax on any basis it chooses and give exemption where it thinks appropriate. Nevertheless, the principles of fairness and ability-to-pay should be considered by the government in setting tax rules, especially in democratic countries where taxation is always used by political opposition parties to criticise government.

(ii) *Timing issues*. Among the main items requiring reconciliation between accounting and tax profits are those affected by timing issues. They include a different useful life to calculate accounting and tax depreciation, different point of recognition for income and expenses, and different treatment for expenses incurred before commencement and after cessation of business. These are the outcome of accounting's matching principle, which necessitates that expenses be matched with income, and the certainty and income-producing requirements under tax principles.

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[259] *Gold Coast Selection Trust Ltd v Humphrey* 30 TC 209; *BHD Sdn Bhd v DGIR* [2008] MSTC 3,682 (SCIT).
[260] IFRS Foundation, *The Conceptual Framework for Financial Reporting,* above n 239, para OB 2.
[261] IFRS Foundation, *The Conceptual Framework for Financial Reporting,* above n 239, para OB 16.

(iii) *Tax incentives*. Apart from the revenue raising function, taxation is also a means to support the government's economic and social objectives. Besides, tax is also used by politicians to promote their political image. Thus various kinds of incentives and disincentives are embedded in the tax system, and they are a long way removed from the concerns of accounting. These tax incentives, together with the non-deductibility of some business expenses, are among the main reasons for the gap between statutory and effective corporate tax rates.[262]

(iv) *Standard-setting body*. Accounting's standard setting body is a private organisation. Tax rules are the result of decisions by the legislature, the judiciary and relevant government agencies. It is certainly the case that they would not pass their control over taxation to a private body. At the same time, governments support the adoption of internationally recognised accounting standards as this would enhance confidence among foreign investors and attract more multinational companies.

Nevertheless, accounting bodies and the tax authority have been working closely to narrow any gaps, where possible, between accounting and tax treatments. In Malaysia, the main accountants' groups, the MIA, the MICPA and the Chartered Tax Institute of Malaysia (CTIM), are working together as part of the Joint Tax Working Group on Financial Reporting Standards to discuss the tax implications resulting from the adoption of IFRSs.[263] The group then produces discussion chapters which include proposals for tax changes to ease taxpayers' compliance burden.

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[262] Alfred V Tran, 'Causes of the Book-Tax Income Gap' (1998) 14(3) *Australian Tax Forum* 253, 283; Claes Norberg, 'Kari Tikka Memorial Lecture: Accounting and Taxation' in Michael Lang and Frans Vanistendael (eds), *Accounting and Taxation & Assessment of ECJ Case Law,* 2007 EATLP Congress, EATLP International Tax Series, vol. 5 (IBFD Publication, 2007).

[263] MIA, *Joint Tax Working Group on Financial Reporting Standards* <http://www.mia.org.my/new/psp_taxation_joint.asp>.

3.6 PROPOSED TAX EXPENDITURE BENCHMARK FOR MALAYSIA'S CORPORATE INCOME TAX

If accounting standards are the benchmark tax base, tax treatments that deviate from accounting standards will be identified as tax expenditures and negative tax expenditures. Nevertheless, there are some unavoidable differences between the two systems as a result of structural features of the tax system. Therefore accounting standards require modification in some respects before they can be used to identify the tax benchmark. These structural features are considered as part of the benchmark tax base, thus they should not be classified as tax expenditures or negative tax expenditures. The proposed elements of a tax expenditure benchmark for corporate income tax are presented in Figure 3.1 below.

Figure 3.1 : Benchmark Tax Structure for Malaysia's Corporate Income Tax

BENCHMARK TAX STRUCTURE FOR MALAYSIA'S CORPORATE INCOME TAX
• Tax base is company profit based on Malaysia's approved accounting standards. • Income is based on nominal value. • Tax unit is a legal person i.e. individual company. • Tax period is the company's accounting period. • Tax rate is 25 per cent. • All income is taxable. This includes foreign source income and capital gains. • Any rules to reduce or eliminate double taxation, such as double tax relief,

The tax base chosen for the corporate income tax benchmark is a company's profit calculated on the basis of approved accounting standards. Therefore the tax base includes all business income earned less all business expenses incurred to produce the income, including accounting depreciation and amortisation. However, the application

of accounting standards is tempered by inclusion of anti-tax avoidance measures, which means that tax treatments which are implemented to prevent tax avoidance, such as restricted deductions for charitable donations, are part of the benchmark and therefore are not tax expenditures.

Each individual company is a tax unit and subject to income tax. The taxable period follows the accounting period - usually one year - but this could be less or more under certain circumstances (such as the first period in business). A single rate, 25 per cent, is used as the benchmark tax rate. The benchmark scope of charge is worldwide income, that is, all income, whether derived from within Malaysia or outside Malaysia, is chargeable to Malaysian tax.

3.7 SUMMARY

Although there are so many critiques with regard to the tax expenditure concept, most tax scholars agree that tax expenditure analysis and reporting are important government tools. As such, while many are still sceptical about the best tax base and question the reliability of tax expenditure measurement, most governments in developed countries offer some kind of tax expenditure reporting and some developing countries are doing the same. But this does not mean that discussions and suggestions about these issues should stop. There is very great room for improvement in every aspect of tax expenditure analysis and reporting, including the best benchmark, the method of measurement, the information to be disclosed and the method of analysis.

Having a separate benchmark tax base for corporate income tax based on accounting standards has its own benefits. There may be some transactions the characterisation of which is debateable, but the issue of inherent differences between accounting and taxation could partly be solved by the inclusion of anti-tax avoidance measures as part of the benchmark. It is hoped that, with this new proposed benchmark, companies are taxed on the basis of their business performance. Tax treatments that are not related to measuring corporate income, or business expenses that are not deductible due to rules developed more than a century ago, are highlighted and further scrutinised. If required,

further actions which should be taken to rectify the situation are proposed. Corporate income tax expenditures identified using the benchmark developed in Section 3.6 are presented in Chapters Four and Five, while corporate negative income tax expenditures are presented in Chapter Six.

CHAPTER FOUR

A TAX EXPENDITURE ANALYSIS OF MALAYSIA'S ECONOMIC CORPORATE INCOME TAX EXPENDITURES

4.1 INTRODUCTION

For the purpose of this thesis, corporate income tax expenditures are corporate tax treatments that deviate from the elements of tax expenditure benchmark, and which reduce the amount of tax payable. The benchmark, as discussed in Chapter Three, has two distinctive elements; accounting standards as the tax base (instead of the widely accepted benchmark that uses S-H-S income) and anti-tax avoidance measures, which are brought into the benchmark to cater for the inherent differences between accounting and tax. Hence, while most of the government incentives are tax expenditures, several tax incentives are not tax expenditures as they actually conform to the benchmark tax structure. On the other hand, a few tax rules that are regarded as standard practices in Malaysia's tax system have been identified as tax expenditures by this thesis due to their deviations from the tax expenditure benchmark.

Corporate income tax expenditures are categorised based on their functions – that is, the objectives they are trying to achieve – and are divided into two large groups, economic tax expenditures and social tax expenditures. The economic tax expenditures are those introduced to strengthen the nation's economy. The social tax expenditures support the country's social development, which includes human capital development, the improvement of living standards and other social activities. This chapter identifies economic tax expenditures that arise from legislation, judicial decisions and administrative practices and analyses the economic tax expenditures based on the conventional tax expenditure analysis framework. A similar analysis for social tax expenditures is available in the next chapter (Chapter Five).

The objectives of each tax expenditure are determined based on government's intention when introducing the incentive, deduced mainly from annual budget speeches. When this is not available, other sources such as books, journal papers and parliamentary debates are used. If none can be found, objectives of the tax expenditures have been assumed from the contents of the tax rule itself.

The tax expenditures are presented based on guidelines for tax expenditure reporting offered by the IMF and tax scholars as discussed in Section 3.2.5,[264] but restricted to availability of information, particularly with relation to estimated revenue forgone. Each of the tax expenditure displays its tax expenditure type (whether it is a deduction, an allowance, an exemption etc.), a brief description on how it works, its reason or objective, the duration and the source. This thesis includes only economic corporate tax expenditures that are in force as at 30 June 2012. Tax expenditures that have expired, even though they still are enjoyed by some companies, are excluded from the list. The tax expenditures are presented in a way that, should the government decide to produce a tax expenditure report, it can use this chapter as a ready list for publication by removing the tax expenditure analysis.

In addition, alternative classification for economic tax expenditures is provided in Section 4.12, where economic tax expenditures are categorised based on the needs of the ministries or government agencies, so that they can be allocated and assessed in the same manner as direct spending. This chapter also recognises government incentives that are part of the tax benchmark and hence not regarded as tax expenditures.

The economic tax expenditures are divided into eight different functional categories. Generally, the government introduced these tax expenditures to assist certain industries or activities that are considered important to the nation and can bring it economic benefits. The functional categories within the economic corporate income tax expenditures and the description of each category are as follows:

[264] IMF Fiscal Affairs Department, above n 177, 64-65; Burton and Stewart, above n 4, 14-15.

a. *Manufacturing and agriculture.* Tax expenditures in this category are mainly to promote investment and improvement in the manufacturing and agricultural sectors. Although manufacturing and agricultural are two different sectors, they are grouped together in this thesis as they receive many similar incentives, probably because they are interrelated in the way that agricultural harvest is used as the material in manufacturing process. Included in this category are food productions, machinery and equipment used in manufacturing and agricultural activities, and the development of products within these two sectors.

b. *Corridors and regional areas.* Malaysia has many economic corridors, each of them with different targets. Many tax expenditures are introduced to stimulate development of corridors and regional areas created by the government which include promoted areas, Iskandar Malaysia (IM), Multimedia Super Corridor Malaysia (MSC Malaysia) and North Corridor Economic Region (NCER).

c. *Hotel and tourism.* Tax expenditures in this category aim to attract more tourists into Malaysia and to ensure the country has adequate facilities to accommodate them.

d. *Financial services.* The purpose of tax expenditures in this category is to enhance competitiveness of Malaysia's financial services industry and to promote Malaysia as an Islamic finance hub.

e. *Balance of payments.* Balance of payments is the term used to describe the inflows and outflows of money into and out of a country. Usually a country seeks to have more money flowing into it than out. The objective of tax expenditures in this category is to strive for a positive balance of payments account by encouraging exports and reducing outflow of money to other countries.

f. *Research and development*. Continuous research and development (R&D) is always preferred as it supports and strengthens the development of other sectors such as manufacturing and agriculture by producing new and innovative products, which in turn could improve the balance of payments account through increased

exports. Tax expenditures in this category promote companies to undertake or support R&D activities and to encourage commercialisation of R&D findings.

g. *Services.* The goal of tax expenditures in this category is to strengthen the services sector to be one of the key players in economic development. Financial services and hotel and tourism, which are also part of services sector, are put as separate categories due to their significance.

h. *Other economic affairs.* This category is subdivided into three functions. The first category is for companies in general, where tax expenditures aim to assist in growth of all companies, and to reduce the costs of doing business. The second category is for tax expenditures that provide support and assistance towards the development of SMEs. The third category gives incentives to companies within the oil and gas industry.

4.2 TAX EXPENDITURE ANALYSIS FRAMEWORK

Since tax expenditures are substitutes to direct spending, they should be analysed in the same way – that is, as expenditure tools, rather than revenue raising tools.[265] Before tax expenditures can be identified and the tax expenditure analysis can be performed, analysts need to first specify the structural provisions of the country's income tax system.[266] This part was covered in Chapter Three. Any tax provisions that deviate from the benchmark tax structure are listed as tax expenditures, and hence subject to tax expenditure analysis.

A tax treatment identified as tax expenditure does not mean that it is a bad fiscal policy. Likewise, not all direct spending is a good policy. This is where the tax expenditure analysis is essential – to provide sufficient information to policymakers, enabling them to decide on the optimal policy to achieve the desired goal and improve the utilisation

[265] Surrey, 'Tax Subsidies as a Device for Implementing Government Policy', above n 11, 197-198; Maktouf and Surrey, above n 11, 744; Adler, above n 132, 861.
[266] Surrey, 'Tax Expenditure Analysis: The Concept and Its Uses', above n 12, 4.

of government resources. The benchmark tax structure helps to identify which tax provisions should be further scrutinised. Sometimes, when a tax expenditure is converted into an equivalent direct spending programme, it may be clearer that the incentive is not optimal policy.

Tax expenditure analysis involves the following three steps:[267]

i. *Identify Tax Expenditures and Negative Tax Expenditures*. The first step to the tax expenditure analysis is to determine the tax rule that deviates from the benchmark tax structure. Any deviation that leads to a reduction in tax revenue collected by the government compared to the tax that would be collected under the neutral benchmark tax is a tax expenditure. On the other hand, any deviation that causes an increase in government's tax revenue collection is a negative tax expenditure.

ii. *Reasons for Government Intervention.* The second step involves considering whether there is a plausible market failure, positive externality or negative externality that might justify government intervention to subsidise or penalise the type of behaviour affected by the measure. Although usually when a new tax expenditure is announced in the annual budget speech the minister would state the reason or objective behind the government assistance, a further analysis is required to determine whether the government's claim is valid. Not all problems require government intervention; sometimes the issue is better left to be corrected by the market. Furthermore, the objective of each tax expenditure should reflect a government spending priority.[268] In addition, a study should be conducted from

[267] Surrey, 'Tax Subsidies as a Device for Implementing Government Policy', above n 11, 200; Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 691-696; Surrey, 'Tax Expenditure Analysis: The Concept and Its Uses', above n 12, 12; Gordon J Lenjosek, 'A Framework for Evaluating Tax Measures and Some Methodological Issues' in Hana Polackova Brixi, Christian M A Valenduc and Zhicheng Li Swift (eds), *Tax Expenditures-Shedding Light on Government Spending through the Tax System* (The International Bank for Reconstruction and Development / The World Bank, 2004) 19, 19-23; Fleming and Peroni, 'Reinvigorating Tax Expenditure Analysis and Its International Dimension', above n 145, 525; Neil Brooks, Jinyan Li and Lisa Philipps, 'Tax Expenditure Analysis: State of the Art' in Lisa Philipps, Neil Brooks and Jinyan Li (eds), *Tax Expenditures: State of the Art* (Canadian Tax Foundation, 2011) 1:1, 1:11-1:12.

[268] Brooks, above n 1, 241.

time to time to measure to what extent the objective has been achieved, and whether the tax expenditure is still relevant. Besides, it is also essential to study the recipient of the tax expenditures and the amount spent, and whether they are justified.[269]

iii. *Alternative Policies.* If the government intervention can be justified, is a tax expenditure the best mode of deliverance? Should it be delivered through as a direct expenditure or another policy instrument, such as a government regulation?[270] All methods may be used to achieve the objective. However, there needs to be a cost-benefit analysis to decide on the best method that can efficiently achieve the objective with optimum use of government resources.

Various approaches have been proposed to perform the comparative cost-benefit analysis. A tax expenditure is said to be justified when it can correct a market failure, is appropriately targeted at needy groups, does not unduly compromise the progressivity of an income tax, avoids unintended economic disruptions and is more cost effective than a direct spending programme.[271] Prof. Kerrie Sadiq suggested tax expenditures should be analysed from four different perspectives – whether they are economically more efficient than direct spending, whether they can be administered more efficiently than direct spending, whether the policy goal is better achieved through tax expenditures than through direct spending, and lastly how the tax expenditures affect stakeholders (including the recipient of tax expenditures, the tax office staff, and other non-recipient taxpayers).[272] Christopher Heady proposed to divide tax expenditures into four categories – those for technical purpose, those for social benefit, those that provide preferential

[269] Surrey and McDaniel, 'The Tax Expenditure Concept and the Budget Reform Act of 1974', above n 11, 692; Sadiq, 'The Implementation of Social and Economic Policy through the Tax Regime', above n 129, 352-354.

[270] Roin, above n 163, 623; Brooks, above n 1, 241.

[271] The Century Foundation Working Group on Tax Expenditures, *Bad Breaks All Around* (The Century Foundation Press, New York, 2002) cited in Hungerford, above n 169, 11.

[272] Kerrie Sadiq, 'The Implementation of Social and Economic Policy through the Tax Regime' above n 129, 348-356; Sadiq, 'An Analysis of Tax Expenditure versus Direct Expenditure', above n 130, 2.

tax treatment of social benefits, and those that are designed to modify behaviour.[273] Analysis is done separately for each category.

These steps allow a tax expenditure to be examined in detail. A tax expenditure that passes all three steps may continue to be a tax expenditure. Others may need some modifications, and may either be transformed into a direct spending program, or remain as a tax expenditure but in a different design. In some cases, government regulations could offer the most effective and optimal solution. Tax expenditures that fail the first step should be removed.[274]

Tax expenditure analysis is a continuous process. Relevancy and adequacy of tax expenditures must be regularly reviewed since business environments, as well as factors that affect business environments such as technology, culture, regulation and politics, are constantly changing. Some tax and policy analysts even call for tax expenditures to be introduced as sunset legislation, which means that they are valid only for a certain period.[275] After expiry, further analysis is needed to decide whether they should be renewed or abolished.

For the purpose of this thesis, tax expenditure analysis is divided into two parts. The first part in Section 4.3 discusses in general the equivalent direct spending program for each type of corporate tax expenditure. The second part, in Sections 4.4 until 4.11, reports on detailed tax expenditures based on their functions, examines the reasons for government intervention and provides a further analysis of each tax expenditure, including how they benefit the recipients, whether they can achieve government intended objectives and whether the current policy is the best. If tax expenditures within the same function can be analysed together, analyses are provided at the end of the category. If it is to be analysed as a single item, an analysis is available immediately after the table.

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[273] Heady, above n 236, 2:9-2:14.

[274] Surrey, 'Federal Income Tax Reform', above n 2, 361-362.

[275] Anne Singer, 'Five Steps Toward a Better Tax Expenditure Debate' (Institute on Taxation and Economic Policy, October 2012) 1 <http://www.itep.org/pdf/fivesteps_1012.pdf>; Andy Nicholas, 'Every Dollar Counts: Why it's Time for Tax Expenditure Reform' (Washington State Budget and Policy Center, 8 February 2011) 6 <http://budgetandpolicy.org/reports/every-dollar-counts-why-its-time-for-tax-expenditure-reform/pdf_version>.

4.3 TYPES OF CORPORATE TAX EXPENDITURES AND THEIR EQUIVALENCE TO DIRECT SPENDING

Tax expenditures can be delivered in many different forms. In this thesis, five types of tax expenditures have been identified – allowance, tax exemption, double deduction, preferential tax rate, and deferral. The following paragraphs explain briefly these tax expenditures and how they could be replaced by direct spending:

(i) *Tax exemption.* This type of tax expenditure arises when income from a favoured activity is fully or partly exempted from tax. In accounting, all business income must be included in the calculation of profits. Therefore, when certain income is excluded in arriving at taxable income, it is a tax expenditure.

(ii) *Allowance.* Allowance is when a certain amount (usually a percentage) is given permission to be deducted in the calculation of taxable income. In accounting, nothing other than business expenses are deductible. Hence, all allowances are tax expenditures.

A large number of Malaysia's corporate income tax expenditures are given in terms of allowances. The two most common types of allowances are pioneer status and investment tax allowance. These two incentives, governed by the PIA 1986, are offered to companies that undertake new investments in "promoted activities and promoted products". The promoted activities or promoted products can be undertaken by a newly formed company, or an existing company that wishes to expand into new line of business. They are awarded to companies in industries identified as important and significant to support economic growth. Nevertheless, there are a few social tax expenditures under these two tax incentives. These incentives are mutually exclusive, which means only one incentive can be claimed at one time. More details regarding these incentives are given below.

a. Pioneer Status

Pioneer status was one of the first tax incentives introduced in Malaysia. It was first enacted under the *Pioneer Industries (Relief from Income Tax) Ordinance 1958*. This was later repealed and replaced with the *Investment Incentives Act 1968*, which offered more tax breaks to pioneer status companies. Under these two laws, pioneer status was specific only for manufacturing companies. In 1986, the *Investment Incentives Act 1968* was replaced by the PIA 1986. This new Act brought with it lavish incentives for pioneer companies, and the status is now offered to other sectors including agriculture, hotel and tourism, and R&D.[276]

The general exemption rate provided to pioneer companies is 70 per cent of statutory income[277] derived from promoted activities or promoted products, for a period of five years. Any unabsorbed capital allowances and accumulated losses during the pioneer period cannot be carried forward to the post pioneer period (with the exception of unabsorbed losses of a contract R&D company).[278] Certain sectors have received higher exemption rates and/or longer exempt periods.

Application for pioneer status is submitted to the MIDA, not the IRBM. Thus approval and monitoring are performed by MIDA. Approved companies receive a certificate from MIDA and present it to the IRBM in order to enjoy the incentive. In addition, to ease tax administration, companies that have been awarded pioneer status cannot be involved in other business activities except with prior consent. If the companies received permission to undertake non-promoted business activities/products, separate accounts must be kept for the promoted activities/products.[279]

The list of promoted activities and promoted products are available in the following gazette orders and may be amended from time to time.

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[276] OECD, *Foreign Direct Investment and Recovery in Southeast Asia* (OECD Publications, 1999) 125-126.
[277] Statutory income is arrived at after deducting allowable expenses and capital allowances from gross income. This has been illustrated in Section 2.5.2.
[278] PIA 1986, ss 18(7), 25.
[279] PIA 1986, s 43A.

i. Promotion of Investments (Promoted Activities and Promoted Products) Order 2012.[280]
ii. Promotion of Investments (Promoted Activities and Promoted Products for Selected Industries) Order 2012.[281]
iii. Promotion of Investments (Promoted Activities and Promoted Products for High Technology Companies) Order 2012.[282]
iv. Promotion of Investments (Promoted Activities and Promoted Products for Reinvestment) Order 2012.[283]
v. Promotion of Investments (Promoted Activities and Promoted Products for Small Scale Companies) Order 2012.[284]

b. Investment Tax Allowance

The PIA 1986 offers investment tax allowance as an alternative tax incentive to pioneer status. Like pioneer status, investment tax allowance is offered to companies involved in promoted activities or promoted products, and companies wishing to claim this allowance should submit their application to MIDA. As the two incentives are mutually exclusive, companies must choose the allowance that has the most potential to benefit them. Since the investment tax allowance is

[280] The Promotion of Investments (Promoted Activities and Promoted Products) Order 2012 can be viewed at <http://www.federalgazette.agc.gov.my/outputp/pua_20120302_P.U.%20%28A%29%2062%20PERINTAH%20PENGGALAKAN%20PELABURAN%20%28AKTIVITI%20DIGALAKKAN%20DAN%20KELUARAN%20DIGALAKKAN%29%202012.pdf>.

[281] The Promotion of Investments (Promoted Activities and Promoted Products for Selected Industries) Order 2012 can be viewed at <http://www.federalgazette.agc.gov.my/outputp/pua_20120302_PERINTAH%20PENGGALAKAN%20PELABURAN%20%28AKTIVITI%20DIGALAKKAN%20DAN%20KELUARAN%20DIGALAKKAN%20BAGI%20INDUSTRI%20TERPILIH%29%202012.pdf>.

[282] The Promotion of Investments (Promoted Activities and Promoted Products for High Technology Companies) Order 2012 can be viewed at <http://www.federalgazette.agc.gov.my/outputp/pua_20120302_PERINTAH%20PENGGALAKAN%20PELABURAN%20%28AKTIVITI%20DIGALAKKAN%20DAN%20KELUARAN%20DIGALAKKAN%20BAGI%20SYARIKAT%20BERTEKNOLOGI%20TINGGI%29%202012.pdf>.

[283] The Promotion of Investments (Promoted Activities and Promoted Products for Reinvestment) Order 2012 can be viewed at <http://www.federalgazette.agc.gov.my/outputp/pua_20120302_PERINTAH%20PENGGALAKAN%20PELABURAN%20%28AKTIVITI%20DIGALAKKAN%20DAN%20KELUARAN%20DIGALAKKAN%20BAGI%20PELABURAN%20SEMULA%29%202012.pdf>.

[284] The Promotion of Investments (Promoted Activities and Promoted Products for Small Scale Companies) Order 2012 can be viewed at <http://www.federalgazette.agc.gov.my/outputp/pua_20120302_PERINTAH%20PENGGALAKAN%20PELABURAN%20%28AKTIVITI%20DIGALAKKAN%20DAN%20KELUARAN%20DIGALAKKAN%20BAGI%20SYARIKAT%20KECIL-KECILAN%29%202012.pdf>.

given as a percentage of qualifying capital expenditure (QCE),[285] it suits companies that invest heavily in capital expenditure.

The rate of allowance is 60 per cent of QCE, deductible against 70 per cent of statutory income, for a period of five years. For certain activities/products, the rate of allowance is increased to 100 per cent, and/or is deductible against 100 per cent of statutory income, and is awarded for an extended period of 10 years. Any unutilised allowance can be carried forward to future years until fully claimed.[286] Similar to the requirements of attaining pioneer status, separate accounts must be kept for the promoted activities/products if the same company is running both promoted and non-promoted business activities.[287]

Apart from pioneer status and investment tax allowance, other allowances are also offered to companies. Infrastructure allowance is granted to companies that incur capital expenditure on infrastructure in promoted areas.[288] There is also reinvestment allowance, offered to companies that have been in operation for more than three years and intend on expanding, modernising or automating its existing business.[289] Both infrastructure and reinvestment allowances are given as a percentage of capital expenditure incurred. In addition, general allowances can be given based on specific expenditure or cost incurred in relation to a favoured activity.

(iii) *Double deduction.* Taxation allows for several deductible expenses to be deducted twice; the second deduction is an incentive. This is never permitted by accounting standards. As such, all double deductions are tax expenditures.

(iv) *Preferential tax rate.* As explained in Section 3.2.2 (ii), preferential tax rate arises when tax is calculated on a rate lower than the benchmark and available only to certain groups or activities. A preferential tax rate for some enterprises is

[285] Includes factory, plant, machinery and other equipment used for the approved project.
[286] PIA 1986, s 29A.
[287] PIA 1986, s 43A.
[288] PIA 1986, s 41B.
[289] ITA 1967, sch 7A paras 1, 8.

inconsistent with a neutral tax system as it in effect subsidies those businesses that enjoy a lower tax rate on their profits. The benchmark tax rate for corporate income tax in Malaysia is 25 per cent. Thus any rate lower than 25 per cent is a tax expenditure.

(v) *Tax deferral.* A tax measure is considered to be a tax deferral when the tax treatment causes payment of tax to be delayed to future periods. This may be the result of accelerated deductions or deferred recognition of income. Tax deferrals resulting from accelerated deductions can occur, for example, when an expense is deductible immediately in the calculation of tax, while in accounting the expense is spread over several years. Another example is in the case of capital allowance, when a greater amount is deductible in the earlier life of the asset, or within a shorter time period, than in accounting. Normally this would occur in the tax system as an accelerated capital allowance given to non-current assets. It also includes an accelerated capital allowance for intangible assets, although the Malaysian tax system does not identify tax deferral on intangible assets as an accelerated capital allowance, most probably because no capital allowance scheme is available for intangibles. In addition, an initial allowance under the capital allowance scheme, given on top of the annual allowance in the first year of the asset, is also considered as tax deferral.

Tax exemptions, allowances, double deductions and preferential tax rates are usually given to encourage or to assist businesses to engage in certain industries or activities. They all have the same effect – they cause a reduction in tax revenue collected by the government. The government is willing to lose some amount of income from one activity in the hope that more income will be generated from other related activities. For example, when half of the income from organising car and motorcycle races in Malaysia is exempted from income tax, the government is expecting more income would flow from tourism through spending in hotels and shopping.

If tax exemptions, allowances, double deductions and preferential tax rates are converted into direct spending, they can be offered as grants or cash benefits to companies involved in government-preferred activities. Whether a grant is preferred

over these tax expenditures depends on their respective administration. Normally, an application for a grant is a lengthy and bureaucratic process, and one several companies may be keen to avoid. The nature of the process is necessary to avoid grant money misuse. Even with its precautions, however, corruption and bribery still occur.

Tax exemptions, allowances, double deductions and preferential tax rates that require prior approval by specific government bodies all resemble a government grant. While a grant is given before the favoured activity takes place, tax exemptions are given after the activity has happened. It is easier to examine an event that has taken place rather than monitoring an activity that is still under planning. If no prior approval is required, this means the responsibility to check the validity of the activity falls to the IRBM. Nevertheless, since tax exemptions, allowances, double deductions and preferential tax rates can only be claimed after the preferred event has happened, no monitoring is required. Even so, tax audit still plays an important role to make sure all claims are legitimate.

Under government grants, money is received before works are done. On the other hand, allowances given as a percentage of income could only be claimed if income has been successfully generated. It is possible that different results are generated depending on whether the reward is received before or after the hard work is done. However, more research is needed before a conclusion on this matter can be made.

Another form of grant is a forgivable loan, which is a loan converted into a grant on the fulfilment of conditions.[290] This type of grant is reminiscent of tax expenditures, where the favoured activity must take place before companies can receive a grant. This reduces the risk of the grant money being misused. Another type of grant is one given while the activity takes place. Rather than a cash payment, a grant in this form is paid directly to the supplier or contractor of the business based on invoice claims made.[291]

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[290] Example of this type of grant is Rural Economic Funding Scheme offered by SME Bank of Malaysia. For further information see <http://www.smebank.com.my/web/guest/skim-pembiayaan-ekonomi-desa>.

[291] Example of this type of grant is Improvement of Production and Premise of Agriculture Based Industries Entrepreneur Matching Scheme offered by the Ministry of Agriculture and Agro-Based

For grants that do involve payments of cash, recipients are required to submit periodical reports as part of the monitoring process.[292]

Based on the information available on the websites of various government agencies, including ministries and government banks such as SME Bank, Malaysia Development Bank and Agrobank, it appears that most of the financial assistance offered is in the form of soft-loans that offer below-market interest rates. Little information on grants can be found. Whether the combination of soft loan and tax expenditures works better than government grants requires separate research.

Although tax exemptions, allowances, double deductions and preferential tax rates have the same effect – reducing tax liability – their impacts on loss-making companies could differ depending on how each tax expenditure is calculated. Loss-making companies are usually considered the needy group; hence this group should be given priority to receive the government's assistance. Tax exemptions and double deductions affect the calculation of adjusted income; hence if a company is suffering loss, both tax exemptions and double deductions are included in "current year business loss" and can be used to set-off with business income from other sources. If the company has insufficient income in the current period, the loss, which includes the tax reduction through tax exemptions and double deductions, can be carried forward to future periods. Investment tax allowance and reinvestment allowance too benefit loss-making companies, because these allowances are calculated based on the amount incurred on capital expenditure, and if part of the allowance cannot be fully absorbed, it can be carried forward to future periods. Nevertheless, that would mean government assistance can only be received when a company is making profits, whereas it is needed most when the company is facing financial difficulties.

In the case of pioneer status, where the allowance is calculated based on statutory income, the allowance can be claimed only if the company makes profit. The higher

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Industry Malaysia. For further information see <http://www.moa.gov.my/web/guest/skim-pemadanan-untuk-peningkatan-pengeluaran>.

[292] Example for this type of grant is Creative Industry Grant offered by the Ministry of Information Communications and Culture Malaysia. For further information see <http://www.kpkk.gov.my/index.php?option=com_content&view=article&id=4850&Itemid=202&lang=en>.

the profit (that is, the statutory income) is, the higher the allowance. Unfortunately, if statutory income is zero, the allowance is also zero. In addition, the losses incurred during the pioneer period cannot be carried forward to the post-pioneer period (except for Contract R&D Company with pioneer status).[293] Thus pioneer status companies cannot get any advantage from the allowance if they cannot make profits. The conditions could in fact be better if they do not apply for pioneer status at all, because under normal circumstances, losses can be carried forward. Similarly, a preferential tax rate cannot be enjoyed by a company that has no total income.

It is for this reason that refundable tax credit is often the most preferred method of tax expenditure. Under this method, a loss-making company receives a cash refund if the amount of tax expenditure that the company is entitled to exceeds the amount of tax payable. Nevertheless, the original government intention for offering the tax expenditures must be clarified. If incentives are intended as a reward for good performance, then perhaps tax expenditure given only to profitable companies is justified. If, however, the tax expenditures are intended to assist companies to survive in the industry, especially newly established companies and SMEs that have difficulties raising external financial assistance, a grant or a refundable tax credit could be better at achieving the government objectives.

Whether the current tax expenditures can achieve their intended objectives requires further study. It is also difficult to say whether a tax expenditure or a grant is a better option based on currently available information – no extensive tax expenditure report exists showing the revenue forgone from tax expenditures. Nevertheless, tax expenditures have one major drawback – it is offered as a blanket incentive available to all companies involved in the activity. Companies earning billions of profits are just as eligible to receive government assistance as a struggling one. For this reason, the general contention is grants and loans are a better way to assist companies.

Another major concern for tax exemptions and allowances is that they are exposed to the risk of abuse. When only certain types of business activities undertaken by the

[293] PIA 1986, s 25.

companies are exempted from tax or eligible for allowances, companies are required to maintain a separate account for those activities. This creates opportunities for tax evasion, where companies can shift non-eligible income and expenses into the separate account to maximise tax incentives and hence reduce tax payable.

Tax deferral has a different effect from the other tax expenditures. It defers payment of tax to future periods, which means companies pay less tax now but pay more tax later. If the inflation rate is ignored, total tax payable over the affected years would be the same.

While accelerated capital allowance is granted to encourage investment in certain types of assets, initial allowance has no clear objective, and only exists by virtue of its inheritance from the British capital allowance scheme. It should be removed from Malaysia's capital allowance scheme. This matter is further discussed in Section 4.11.1(e).

When converted into direct spending, accelerated capital allowance is akin to an interest-free loan provided by the government to businesses.[294] The loan is given within the period of accelerated capital allowance, and payable in the following years where the asset is still in use in the form of higher tax payable. On the surface this looks acceptable; however there is a risk that the needy group may miss out. The allowance is available to businesses that have purchased the qualifying assets, but to purchase the assets requires financial resources. Access to financial resources could be difficult, especially to SMEs.

Nevertheless, the Malaysian government has already offered several loan and credit facilities exclusively to SMEs through various government agencies.[295] Loans are also

[294] Michael Cragg and Joseph E Stiglitz, 'Should the Government Invest, or Try to Spur Private Investment?' (2011) (April) *The Economists' Voice* 1, 1; Review of Business Taxation, 'A Platform for Consultation' (Discussion Paper 2: Building on a Strong Foundation, Review of Business Taxation, February 1999) 117.

[295] Moha Asri Abdullah and Siti Khadijah Ab Manan, 'Adequacy of Financial Facilities for Small Businesses in Malaysia: Preliminary Findings' (Paper presented at the International Business Research Conference, Dubai, 16-17 April 2009) 5 <http://www.wbiconpro.com/8%5B1%5D.-Asri-.pdf>.

available through commercial banks, with the government agreeing to partly subsidise the profit rate charged (a replacement of interest under the Islamic banking scheme).[296] With all these facilities, converting the accelerated capital allowance into direct spending is not necessary. Besides, the accelerated capital allowance is targeted on a specified objective, which is to encourage businesses to invest in certain assets. In loans the financial resources obtained have a more general usage. It should be noted, however, that not all SMEs have the opportunity to grab the benefits from the various loans offered due to lack of knowledge of the application process and the unavailability of collateral to secure loan.[297] This by no means suggests that the loan facilities should be discontinued. Rather, the system needs improvement.

In terms of efficiency, accelerated capital allowance is simple to administer and does not involve much burden to either businesses or the IRBM staff. It can also minimise red tapes and favouritism involved in the application of loans. The allowance also has the potential benefit of incentivising businesses to invest in particular assets favoured by the government. When under normal circumstances an asset is unlikely to be purchased by businesses due to certain factors, such as higher price, an accelerated capital allowance could modify their behaviour to invest in this particular asset. Of course, more research is required to study how this incentive affects taxpayers' behaviour.

As long as a business has easy access to capital, all large and small firms could benefit from accelerated capital allowance. Loss making companies can carry forward unabsorbed allowances to future years and claim them when they make profits. However, this would mean that they do not receive any advantage from the accelerated allowance, as it has the same effect as the normal capital allowance.[298] Moreover, some economic experts argued that accelerated capital allowance only benefits capital-intensive industries such as manufacturing, and provides little or no benefit to

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[296] Small and Medium Enterprise Corporation Malaysia, *Shariah-compliant SME Financing Scheme* <http://www.smecorp.gov.my/v4/node/1301>.

[297] Nurbani Binti Hassan *et al*, 'Financial Constraints and Opportunities of Micro Enterprise Entrepreneurs: A Theoretical Framework' (2009) 1 *International Proceedings of Economics Development and Research* 165, 165-166.

[298] Cragg and Stiglitz, above n 294,3.

businesses from the services sector.[299] Yet, not all industries require similar incentives. While capital-intensive industries need accelerated capital allowance, service industries can benefit more from incentives on human capital development (which may not benefit capital intensive industry). Instead of giving all industries the same incentive, it is more sensible for the government to provide incentives tailored to the need of each industry. Nevertheless, attention should be given to ensure recipients of accelerated capital allowance are receiving the allowance in accordance with the intended government objectives.

Having an accelerated capital allowance scheme as a stand-alone incentive may not be effective. Rather, to make it a useful tool to promote targeted investment, it should be coupled with other programs that provide incentives to stimulate investment.[300] The current credit facilities offered by the government could support the accelerated capital allowance scheme. However, whether accelerated capital allowance is the correct method to provide subsidy should be analysed on a case-by-case basis. The type of assets that qualify must be reviewed regularly, and other supporting programs must be effective.

4.4 MANUFACTURING AND AGRICULTURE

The following tables provide detail tax expenditures used by the government to promote the development of manufacturing and agricultural sectors. Compared to tax expenditures of other sectors in Sections 4.5 until 4.11, these two sectors have the most tax expenditures, which reflect their importance in the country's economic development. Analysis for tax expenditures for manufacturing and agricultural sectors is grouped together and follows afterwards. An exception is the analysis on accelerated capital allowances, where an explanation of the reasons why they are identified as tax expenditures (that is, the first step) is provided immediately thereafter.

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[299] Cragg and Stiglitz, above n 294, 3; Review of Business Taxation, above n 294, 118.

[300] Nattawoot Koowattanatianchai, Michael B Charles and Ian Eddie, 'Accelerated Depreciation: Assessing a Historical and Contextual Perspective' (Paper presented at the Asia-Pacific Economic and Business History Conference, Gakushuin Universoty, Tokyo, 18-20 February 2009) 20.

4.4.1 Pioneer Status or Investment Tax Allowance for the General Manufacturing and Agricultural Sectors

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 70% of statutory income derived from promoted activities or promoted products, for 5 years; or Investment Tax Allowance of 60% of QCE deductible against 70% of statutory income for 5 years.
Reason(s)	To encourage more companies to involve in promoted activities/products.
Effective Year	- (Incorporated in PIA 1986 when enacted)
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1), 6(1), 14, 21B, 26, 29A. • Promotion of Investments (Promoted Activities and Promoted Products) Order 2012 • MIDA, Incentives for Investment.[301]
Additional Information	- Promoted products and activities within the general manufacturing and agricultural sectors include the following: o Agricultural production o Processing of agricultural produce o Manufacture of rubber products o Manufacture of palm oil products and their derivatives o Manufacture of chemicals and petrochemicals o Manufacture of pharmaceutical and related products o Manufacture of wood-based products o Manufacture of pulp, paper and paperboard o Manufacture of kenaf-based products o Manufacture of textiles and textile products o Manufacture of clay-based, sand-based and other non-metallic mineral products o Manufacture of iron and steel o Manufacture of non-ferrous metal and their products o Manufacture of machinery and machinery components o Supporting products or services

[301] MIDA provides a detailed list of incentives offered to encourage investment governed by MIDA and other government agencies, including IRBM. The list can be viewed at MIDA, *Invest in Malaysia: Incentives for Investment* <http://www.mida.gov.my/env3/index.php?page=incentives-for-investment>.

4.4.1 Pioneer Status or Investment Tax Allowance for the General Manufacturing and Agricultural Sectors (cont'd)

Additional Information	- Promoted products and activities within the general manufacturing and agricultural sectors include the following (cont'd): o Manufacture of electrical and electronics products and components and parts thereof and related services o Manufacture of professional, medical, scientific and measuring devices or parts o Manufacture of plastic products o Protective equipment and devices o Manufacturing related service o Miscellaneous

4.4.2 Pioneer Status or Investment Tax Allowance for Reinvestment in Resource-Based and Food Processing Industries

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 70% of statutory income derived from promoted activities or promoted products, for 5 years; or Investment Tax Allowance of 60% of QCE deductible against 70% of statutory income for 5 years.
Reason(s)	To enhance production and expand the growth of these sectors.[302]
Effective Year	2001, with amendments later
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1DD), 6(1AG), 14, 21J, 26K, 29L. • Promotion of Investments (Promoted Activities and Promoted Products for Reinvestment) Order 2012
Additional Information	Resource-based products are products from rubber, oil palm and wood.

[302] *Malaysian Budget Speech 2002,* paras 50-51, 54; *Malaysian Budget Speech 2003,* Appendix 26.

4.4.3 Pioneer Status or Investment Tax Allowance for Activities and Products that are of National and Strategic Importance

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products, for 5 years, with the eligibility to extend for another 5 years; or Investment Tax Allowance of 100% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To attract more companies to involve in strategic projects with national importance.
Effective Year	1986, with amendments later
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1A), 6(1AB), 14C, 21C, 26A, 29B
Additional Information	Products or activities with national and strategic importance are as determined by MIDA. Generally they involved heavy capital investments with long gestation periods, have high levels of technology, are integrated, generate intensive linkages, and have significant impact on the economy.

4.4.4 Pioneer Status or Investment Tax Allowance for High Technology Companies

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products, for 5 years; or Investment Tax Allowance of 60% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To encourage company involvement in activities or products of new and emerging technology.
Effective Year	- (Incorporated in PIA 1986 when enacted)
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1D), 6(1), 14, 21F, 26F, 29G. • Promotion of Investments (Promoted Activities and Promoted Products for High Technology Companies) Order 2012
Additional Information	- High Technology Company means a company engaged in promoted activities or in the production of promoted products in areas of new and emerging technology.[303] - Promoted activities and promoted products for high technology companies are determined by gazette orders. They come from the following industries: o Design, development and manufacture of advanced electronics and computing o Professional, medical, scientific and measuring devices or parts o Biotechnology o Advanced materials o Alternative energy technology o Iron and steel

[303] PIA 1986, s 2.

4.4.5 Pioneer Status or Investment Tax Allowance for Medical Device Testing Laboratories

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products, for 5 years; or Investment Tax Allowance of 60% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	Medical devices testing laboratories are essential to ensure locally manufactured medical devices are of high quality and up to international standards. This incentive aims to encourage private sectors to invest in such laboratories.[304]
Effective Year	2007
Expiry Year	2012
Source(s)	• PIA 1986 ss 5(1D), 6(1), 14, 21F, 26F, 29G.
Additional Information	Investment in new testing laboratories entitles for pioneer status and investment tax allowance, while investment to upgrade existing testing laboratory entitles for investment tax allowance only.

[304] *Malaysian Budget Speech 2008,* para 103; Appendix 29.

4.4.6 Pioneer Status or Investment Tax Allowance for the Machinery and Equipment Industry

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products, for 5 years, with the eligibility to extend for another 5 years; or Investment Tax Allowance of 100% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To develop local machinery and equipment industries and reduce dependency on imported products.[305]
Effective Year	2001
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1DB), 6(1AE), 14C, 21H, 26I, 29J • Promotion of Investments (Promoted Activities and Promoted Products for Selected Industries) Order 2012
Additional Information	Includes both general and specialised machinery and equipment industries.

[305] *Malaysian Budget Speech 2003,* para 110; Appendix 29.

4.4.7 Pioneer Status or Investment Tax Allowance for Utilisation of Palm Oil Biomass to Produce Value-Added Products

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products, for 5 years, with the eligibility to extend for another 5 years; or Investment Tax Allowance of 100% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To promote investment in the utilisation of palm oil waste, which has high economic potential.[306]
Effective Year	2003
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1DB), 6(1AE), 14C, 21H, 26I, 29J. • Promotion of Investments (Promoted Activities and Promoted Products for Selected Industries) Order 2012
Additional Information	Examples of the value-added products are particleboard, medium density fibreboard, plywood, pulp and paper.

[306] *Malaysian Budget Speech 2002,* para 54; *Malaysian Budget Speech 2004,* para 80; Appendix 5.

4.4.8 Pioneer Status or Investment Tax Allowance for Reinvestment in Utilisation of Palm Oil Biomass to Produce Value-Added Products

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products for 5 years, with the eligibility to extend for another 5 years; or Investment Tax Allowance of 100% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To promote investment in the utilisation of palm waste to produce value-added products.[307]
Effective Year	2003
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1DD), 6(1AG), 14C, 21J, 26K, 29L. • Promotion of Investments (Promoted Activities and Promoted Products for Reinvestment) Order 2012
Additional Information	Examples of the value-added products include particleboard, medium density fibreboard, plywood, pulp and paper.

[307] *Malaysian Budget Speech 2004,* para 80; Appendix 5.

4.4.9 Pioneer Status or Investment Tax Allowance for the Automotive Component Modules Industry

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products, for 5 years; or Investment Tax Allowance of 60% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To encourage involvement in designs, development and production of automotive component modules or systems.[308]
Effective Year	2002
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1DC), 6(1AF), 14, 21I, 26J, 29K.
Additional Information	-

[308] *Malaysian Budget Speech 2003,* para 109; Appendix 28.

4.4.10 Reinvestment Allowance for the Manufacturing and Selected Agricultural Sectors

Type	Allowance
Brief Description	Reinvestment Allowance of 60% of QCE deductible against 70% of statutory income for 15 years. Any unutilised allowance can be carried forward to future periods until fully claimed.
Reason(s)	To encourage the expansion of approved projects.
Effective Year	1979, with amendments later
Expiry Year	-
Source(s)	• ITA 1967 sch 7A • IRBM Public Ruling No 2/2008 Reinvestment Allowance[309] • Income Tax (Prescription of Activity Excluded from the Definition of "Manufacturing") Rules 2012

Additional Information	- Available for manufacturing and agricultural companies that reinvest in qualifying projects that have been in operation for at least 36 months. A qualifying project is:[310]
	  o A project of expanding, modernising or automating existing business in respect of manufacturing of a product or any related product within the same industry, or in diversifying its existing business into any related product within the same industry;
	  o an agricultural project undertaken by a company in expanding, modernising or diversifying its cultivation and farming business, excluding the business of rearing chicken and ducks; or
	  o a project undertaken by a person in transforming his business of rearing chicken and ducks from an opened house to a closed house system, or in expanding his existing business of rearing chicken and ducks in a closed house system.
	- Certain manufacturing activities have been excluded from the definition of manufacturing for this allowance.[311]
	- The allowance can be set off against 100% of statutory income if the business has achieved a certain level of productivity as determined by the Minister of Finance, based on its Process Efficiency ratio.

[309] Following changes to the legislation, this public ruling has been replaced with IRBM Public Ruling No 6/2012 Reinvestment Allowance issued on 12 October 2012.

[310] ITA 1967, sch 7A para 8.

[311] 20 activities have been excluded, which is available in Income Tax (Prescription of Activity Excluded from the Definition of "Manufacturing") Rules 2012.

4.4.11 Pioneer Status or Investment Tax Allowance for Reinvestment in Cold Chain Facilities and Services

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with exemption of 70% of statutory income derived from promoted activities or promoted products, for 5 years; or Investment Tax Allowance of 60% of QCE deductible against 70% of statutory income for 5 years.
Reason(s)	To strengthen the "value-added" chain in the agricultural sector.[312]
Effective Year	2003
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1DD), 6(1AG), 14, 21J, 26K, 29L • Promotion of Investments (Promoted Activities and Promoted Products for Reinvestment) Order 2012
Additional Information	The cold chain facilities and services are provided for perishable agricultural produce (fruits, vegetables, flowers, ferns, meat and aquatic products).

[312] *Malaysian Budget Speech 2004,* paras 148-149; Appendix 14.

4.4.12 Double Deduction for Expenses Incurred to Obtain Halal Certification, Quality Systems and Standards Certification

Type	Double deduction
Brief Description	Revenue expenditure incurred to obtain certification for recognised quality systems and standards, and halal certification, can be deducted twice.
Reason(s)	To encourage food producing companies to obtain halal certification for their products and to ensure the products are of high quality.[313]
Effective Year	2005
Expiry Year	-
Source(s)	• ITA 1967 s 34(6)(ma)
Additional Information	- The certification bodies and agencies must be those approved by the Ministry of Finance. - Although originally this tax expenditure was meant for the food industry, it has been offered to all types of companies.

4.4.13 Investment Tax Allowance for Halal Food Production

Type	Allowance
Brief Description	Investment Tax Allowance of 100% of QCE, deductible against 100% of statutory income for 5 years.
Reason(s)	To boost new investments in the halal food industry and to promote the use of latest machinery and equipment in food production.[314]
Effective Year	2004
Expiry Year	-
Source(s)	• PIA 1986 ss 26M, 29N.
Additional Information	-

[313] *Malaysian Budget Speech 2005,* para 50; Appendix 8.
[314] *Malaysian Budget Speech 2005,* para 51; Appendix 9.

4.4.14 Double Deduction for Freight Charges from Sabah or Sarawak to Peninsular Malaysia

Type	Double deduction
Brief Description	Freight charges for the shipment of manufactured goods from Sabah or Sarawak to any port in Peninsular Malaysia can be deducted twice.
Reason(s)	To allow businesses producing goods in Sabah and Sarawak, who incur increased shipping costs to reach Peninsular Malaysia, to compete nationally and globally.
Effective Year	2000
Expiry Year	-
Source(s)	• Income Tax (Deduction for Freight Charges from Sabah or Sarawak to Peninsular Malaysia) Rules 2000
Additional Information	-

4.4.15 Double Deduction for Advertising Malaysian Brand Name Goods

Type	Double deduction
Brief Description	The cost of advertising Malaysian brand name goods can be deducted twice.
Reason(s)	Part of government's continuous effort to introduce and promote local brands in international markets.[315]
Effective Year	1997
Expiry Year	-
Source(s)	• Income Tax (Deduction for Advertising Expenditure on Malaysian Brand Name Goods) Rules 2002 • Income Tax (Deduction for Advertising Expenditure on Malaysian Brand Name Goods) (Amendment) Rules 2007
Additional Information	- The "Malaysian Brand Name" refers to brands registered in Malaysia or registered overseas as trademarks to Malaysian-owned companies. - Eligible costs of advertising include those incurred in the placing of advertisements on the Internet, in magazines and newspapers, on television, on hoardings, and in trade publications, or the costs of sponsoring a sporting event or trade conference/exhibition. All advertisements must be made and all sponsored events must be held in Malaysia. - Professional fees paid to an advertising agency to promote on the company's behalf are also eligible for this incentive. - In 2007, the incentive has been extended to companies within the same group that incur the advertising expenses.

[315] *Malaysian Budget Speech 2002,* para 49.

4.4.16 Production of Approved Food Products

a. Allowance for Investment in Subsidiaries Engaged in the Production of Approved Food Products

Type	Allowance
Brief Description	Allowance equivalent to the amount invested in the subsidiary company.
Reason(s)	To encourage companies to invest in food production activities and to ensure continuous development in food production.[316]
Effective Year	2001, with amendments later
Expiry Year	2015
Source(s)	• Income Tax (Deduction for Investment in an Approved Food Production Project) Rules 2011
Additional Information	- Approved food production project refers to a project in relation to: a) Planting of kenaf, vegetables, fruits, herbs or spices; b) Aquaculture; c) Rearing of cows, buffaloes, goats or sheep; or d) Deep sea fishing. - Application for this incentive should be submitted to the Ministry of Agriculture and Agro-Based Industry. - The investing company must own at least 70% of the shares in the subsidiary company. The subsidiary company must be approved for tax exemption provided for new projects under the Income Tax (Exemption) (No. 3) Order 2011 (see (b) below).

[316] *Malaysian Budget Speech 2001,* paras 93-94; Appendix 26; *Malaysian Budget Speech 2005,* Appendix 6; *Malaysian Budget Speech 2011,* Appendix 7.

b. Tax Exemption for Companies Engaged in the Production of Approved Food Products

Type	Tax exemption
Brief Description	Income received by companies engaged in the production of approved food products is 100% exempted from tax. First new projects are exempted for 10 years, while expansion of existing projects are exempted for 5 years.
Reason(s)	To encourage companies to invest in food production activities and to ensure continuous development in food production.[317]
Effective Year	2001, with amendments later
Expiry Year	2015
Source(s)	• Income Tax (Exemption) (No. 3) Order 2011
Additional Information	- Approved food production project refers to a project in relation to: o Planting of kenaf, vegetables, fruits, herbs or spices; o Aquaculture; o Rearing of cows, buffaloes, goats or sheep; or o Deep sea fishing. - Application for this incentive should be submitted to the Ministry of Agriculture and Agro-Based Industry. - Any losses incurred before and during the exempt period can be carried forward to the post-exempt period until fully claimed.

[317] *Malaysian Budget Speech 2001,* paras 93-94; Appendix 26; *Malaysian Budget Speech 2005,* Appendix 6; *Malaysian Budget Speech 2011,* Appendix 7.

4.4.17 Accelerated Capital Allowance for the Cost of Acquisition of Proprietary Rights of Manufacturing Companies

Type	Tax deferral
Brief Description	The cost of acquisition of proprietary rights (patents, industrial design and trademarks) incurred by manufacturing companies can be deducted at the rate of 20% per annum for 5 years.
Reason(s)	To accelerate the acquisition of the state-of-the-art technology.[318]
Effective Year	2002
Expiry Year	-
Source(s)	• Income Tax (Deduction for Cost of Acquisition of Proprietary Rights) Rules 2002
Additional Information	-

In accounting, MFRS 138 *Intangible Assets* requires this cost to be amortised over its useful life and tested for impairment.[319] Under the Malaysian law, trademark registration is valid for 10 years, and can be renewed from time to time.[320] A Malaysian registered patent is effective for 20 years,[321] and an industrial design is valid for five years, but is extendable for another two consecutive five-year terms.[322] The tax rule provides an incentive for five years, less than the legal useful life, and this causes a tax deferral.

[318] *Malaysian Budget Speech 2002,* para 35.
[319] IFRS Foundation, *MFRS 138 Intangible Assets*, paras 74-75.
[320] *Trade Marks Act 1976*, s 32(1).
[321] *Patents Act 1983*, s 35(1).
[322] *Industrial Designs Act 1996*, s 25.

4.4.18 Accelerated Capital Allowance for Machinery and Equipment Used in the Agricultural Sector

Type	Tax deferral
Brief Description	Capital allowance of 60 % (20% initial allowance and 40% annual allowance) in the first year and 40% annual allowance in the second year.
Reason(s)	To reduce dependence on labour and to promote mechanisation and automation in the agricultural sector, including plantations.[323]
Effective Year	2005
Expiry Year	-
Source(s)	• Income Tax (Accelerated Capital Allowance) (Machinery and Equipment for Agriculture Sector) Rules 2005
Additional Information	-

MFRS 116 *Property, Plant and Equipment* requires an asset to be depreciated over its useful life, that is, how long the asset is expected to bring benefit to the business.[324] The tax rule allows the cost of the asset (machinery and equipment of agricultural sector) to be written off within two years. The life of the asset should be more than that. The difference in accounting and tax treatments caused a tax deferral, which is a tax expenditure.

[323] *Malaysian Budget Speech 2005,* para 48; Appendix 6.
[324] IFRS Foundation, *MFRS 116 Property, Plant and Equipment*, paras 50, 57.

4.4.19 Accelerated Capital Allowance for Plant and Machinery Used for Reinvestment in Promoted Activities and Promoted Products

Type	Tax deferral
Brief Description	Capital allowance of 60 % (20% initial allowance and 40% annual allowance) in the first year, 20% annual allowance in the second year and 20% annual allowance in the third year.
Reason(s)	To encourage continuous reinvestment among companies involved in promoted activities and promoted products.[325]
Effective Year	2001
Expiry Year	-
Source(s)	• Income Tax (Accelerated Capital Allowances) (Reinvestment in Qualifying Project) Rules 2000
Additional Information	The capital allowance is available upon the expiry of Reinvestment Allowance.

The tax legislation allows the plant and machinery to be written off within three years. If the asset's useful life, used in calculating accounting depreciation, is more than three years, the payment of tax is delayed to a future period and is, thus, a tax expenditure.

In its early years after independence, Malaysia's focus was on its agricultural sector.[326] Since the 1980s more emphasis has been given to the manufacturing sector due to its industrialisation process. However, the agricultural sector is still regarded as important. For decades various incentives have been offered to these two sectors. All of the above tax expenditures have clear objectives; to promote investment in manufacturing and agricultural sectors and to encourage certain activities within these sectors. A more in-depth analysis is undertaken in this section to further scrutinise the validity of these objectives.

Ideally, the demand and supply rule should determine what types of manufacturing and agricultural activities should be in the market. In the absence of a substantial market failure, producers will generate sufficient outputs to meet demand. If the government

[325] *Malaysian Budget Speech 2005,* para 48; Appendix 6.
[326] Jomo Kwame Sundaram and Chris Edwards, 'Malaysian Industrialisation in Historical Perspective' in Jomo Kwame Sundaram (ed), *Industrialising Malaysia* (Routledge, 1993) 14, 18.

intervenes in the market with subsidies (including tax expenditures) to encourage companies to engage in certain government-favoured activities, it must be the case that by persuading companies to offer a product that has little or no demand, the government hopes that the increased supply will create demand. However, looking at the list of tax expenditures for the manufacturing and agricultural sectors, all activities have high economic potential that require no government intervention.

A more plausible explanation for government intervention is that the preferred activities within the manufacturing and agricultural sectors involve high initial capital investment, which could hinder some companies to become involved in these activities. The incentives signal that the government thinks the companies within these two sectors need to be assisted to survive in the market, especially during the early years of the business. The government is willing to help since these two sectors are important in the country's economic development. Hence, most government assistance is offered in terms of pioneer status and investment tax allowance, which are available for the first five to 10 years of operation. However, projects with good prospects should have no problem acquiring loans or other external sources of funding. If an application for a loan is rejected, it indicates that the projects are not feasible or not profitable. In fact, companies usually ensure they would have enough financial resources before they proceed with the application of pioneer status or investment tax allowance. Therefore, the allowances are redundant and unnecessary.

Another possible reason, which is related to the high cost to set up the business, is that the government wants to help cover part of the cost so that it will not be transferred to the consumers. Normally, a price is set after adding profit margin to the cost of production. If the cost is high, so too will be the price. The government is hoping that with the tax expenditure, the price is set within an affordable range and thus does not burden the public. However, it is unlikely for companies to take into account the allowances in setting the sale price, because that would mean after the allowances expire, the sale price needs to be increased. As such, this reason is also rejectable.

There is only one reinvestment allowance for this sector, though it is available for a wide range of activities. The allowance is granted for 15 years to selected

manufacturing and agricultural companies that have been in operation for at least three years. Based on the definition of qualifying projects, the government wants to encourage companies to expand, modernise, automate and diversify their existing operations. The allowance is provided based on capital allowance incurred, which indicates that the government wants companies to upgrade their business. The government has realised that to upgrade would again involve high capital investment; hence this tax expenditure is offered. However, as in the case of pioneer status and investment tax allowance, this matter can be resolved by the companies themselves, without any tax incentives. They could apply for loans or issue new shares to raise additional financial resources.

The same argument can be used for the tax exemption on income from the production of approved food products. Approved food products refers to plantation of kenaf, vegetables, fruits, herbs or spices, aquaculture, rearing of cows, buffaloes, goats or sheep, and deep sea fishing. These are fundamental food items consumed by Malaysians, yet the country still needs to rely on imports to meet demand.[327] Perhaps these types of business are viewed as not attractive among Malaysians due to the nature of business, their level of risk, or the cost involved in setting up the business. Hence, the tax expenditure aims to make the business attractive and at the same time reduce the cost of doing business, with the hope that the price of food will be kept low. Nevertheless, as argued before, there is no guarantee that the tax exemption is considered by the companies when setting the sale price, especially in the case of food products where price is usually set by the market.

As discussed in Section 4.3 above, pioneer status, investment tax allowances, reinvestment allowances and tax exemptions could better assist manufacturing and agricultural companies if they are given in terms of grants or soft loans to help finance the cost of capital expenditure. They provide better targeted funding than the blanket tax expenditures, and permit better spending control for the government. If the government still thinks assistance is better delivered through the tax system, refundable

[327] MIDA, *Industries in Malaysia: Food Industry* <http://www.mida.gov.my/env3/index.php?page=food-industries>.

tax credit offers the best design since the current tax expenditure designs do not adequately assist loss-making companies.

Expenses eligible for double deduction are business expenses that can be deducted twice. Among the 19 tax expenditures for manufacturing and agricultural sectors, three were offered as double deductions: for expenses incurred to obtain halal and quality standards certifications; for freight charges to ship products from Sabah and Sarawak (in Borneo) to Peninsular Malaysia; and for the cost of advertising goods with Malaysian-owned trademarks.

For companies that want to capture the Malaysian food market, halal certification is crucial. In a Muslim-majority country, producing food without a halal certification reduces the target market by more than half. The same goes for quality standards certification. When other products are quality certified, not having the same certification could result in loss of customers. Hence, with or without the double deduction, companies would still get the certifications for their products. However, there may be a few companies that need to be financially assisted to pay for the costs of certification. To deal with these companies, however, grants and loans may be more suitable than double deductions because assistance is provided only for those in need. In addition, if the purpose of tax expenditure for halal certification is to support Malaysia's vision to be the global halal hub,[328] regulation could also be used to make halal certification compulsory for all food products (with the exception of foods from non-halal sources such as pork and wine).

The double deduction for freight charges from Sabah or Sarawak to Peninsular Malaysia is to help keep the price of products from Sabah and Sarawak lower than or at least equal to products from neighbouring countries that are closer to the Peninsular Malaysia, such as Thailand and Indonesia. Products from these countries already have a lower cost due to the low labour cost. The government believes it has the responsibility to help businesses in Sabah and Sarawak and thus needs to intervene in the market to help lower the cost. Given the distance between the Borneo and

[328] 'Malaysia Set to Become World's Premier Halal Hub', *The Star* (online), 24 June 2010 <http://thestar.com.my/news/story.asp?file=/2010/6/24/nation/6537091&sec=nation>.

Peninsular Malaysia, separated by the South China Sea, the freight cost is unavoidable. Nevertheless, in a perfect market, companies facing similar problems would undertake various strategies to overcome the problem. They could adopt a product differentiation strategy to make their products unique and attractive, allowing them to charge a higher price. They could also manage costs more efficiently so that their products can be sold at lower prices. Alternatively, they can forego the Peninsular Malaysian market and focus on exports. The availability of the double deduction ultimately produces companies that are always dependent on the government.

In regard to the double deduction for the cost of advertising Malaysian brand name goods, there is an inconsistency between its objective and its real-world application. When it was announced in the budget speech, the double deduction's objective was said to be to introduce and promote local brands in international markets.[329] However, expenses eligible for the double deduction only involve the cost of advertisements in Malaysia, and not overseas. A local advertisement can hardly attract international consumers, barring a handful of examples, such as sporting events that can be watched worldwide. Advertisements in local newspapers and television are more targeted to local consumers. Therefore, this tax expenditure should to be reviewed to make sure the indirect government spending does reflect its objective. Nevertheless, advertising and marketing is important for all businesses. Regardless of whether an incentive is available or not, businesses are willing to incur advertising cost. Therefore, this tax expenditure should not be made available. Rather, the government should provide fund or loan only for companies that have financial difficulties to engage in this activity.

There are three accelerated capital allowances for the manufacturing and agricultural sectors. In general, their objectives are to encourage activities that would be engaged by these companies irrespective of the availability of government assistance; thus they are redundant policies. The first accelerated capital allowance is for the cost of acquisition of proprietary rights, which are important to protect the trade secrets so that manufacturing companies can gain a competitive advantage over other competitors. Yet, the main issue for not registering proprietary rights is not a financial limitation, but

[329] *Malaysian Budget Speech 2002,* para 49.

a lack of awareness. The incentive offered cannot increase awareness. The accelerated capital allowance for machinery and equipment used in the agricultural sector is to encourage businesses to switch to the use of machinery and equipment in the agricultural activities and become less dependent on human labour. This measure is part of the long-term solution to the problem of inadequate supply of labour and rising wages in Malaysia's agricultural sector.[330] The decision to switch should naturally come from the management as part of business decision making. Reinvestment in promoted activities and promoted products too are part of normal business cycle and must be undertaken by companies to survive in the market when facing with new competitors. Nevertheless, for the purpose of tax expenditure analysis, assuming that these accelerated capital allowances have justifiable objectives, the same goals can be achieved by giving grant or interest-free loans to businesses, or to provide direct subsidies for products that are regarded as basic human needs. Subsidies should not be made available for luxury products that are consumed only by the high-income bracket of the population.

4.5 CORRIDORS AND REGIONAL AREAS

The Malaysian government has introduced several corridors and regional areas. Promoted areas consist of the states of Kelantan, Terengganu, Pahang, and the district of Mersing in Johor,[331] Sabah, Sarawak, Perlis and Labuan (for the hotel and tourism industry only).[332] IM is located in the state of Johor, MSC Malaysia covers Kuala Lumpur and some parts of the state of Selangor, and NCER encompasses the four states in the north of Peninsular Malaysia – Perlis, Kedah, Penang and Perak (northern part only). All these regions are established with the aim to boost economic expansion in these areas based on promoted activities in specific sectors. Apart from direct spending

[330] Economic and Social Commission for Asia and the Pacific, *Organic Agriculture and Rural Poverty Alleviation: Potential and Best Practices in Asia* (United Nations Publications, 2002) 104-105.

[331] In 2007, the same area, states of Kelantan, Terengganu, Pahang and the district of Mersing in the state of Johor, has been announced to form a new economic corridor known as East Coast Economic Region.

[332] Promotion of Investments (Promoted Areas) Order 1994; Promotion of Investments (Promoted Areas) (Amendment) Order 1998; Promotion of Investments (Promoted Areas) (Amendment) Order 2006.

in terms of facilities and infrastructure, tax expenditures are also used to attract more investors to stimulate the economic development in these areas.

Figure 4.1 : Map of Malaysia

Other additional corridors have been announced in recent years. Nevertheless, all these regions form part of the promoted areas, and the tax incentives offered for investment in these regions already exist in promoted areas. Hence no tax expenditures in these regions are discussed in this thesis. The state of Perlis, which is part of NCER, is also one of states in the promoted areas. Brief descriptions of these regions are provided below. Figure 4.1 shows the map of Malaysia to highlight the location of each state.

- East Coast Economic Region, announced in 2007, contains the eastern part of Peninsular Malaysia that is, the states of Kelantan, Terengganu and Pahang, and the district of Mersing in Johor. The region focuses on five clusters as the economic

drivers based on their strength in the region – tourism, oil, gas and petrochemical, manufacturing, agriculture, and education.

- Sabah Development Corridor covers the whole state of Sabah. Launched in 2008, its key economic drivers are tourism, agriculture, manufacturing and logistics.
- Sarawak Corridor of Renewable Energy, located in the central of the state of Sarawak, was launched in 2008 to take advantage of the rich energy resources in the area. Although it is open to all industries, there are 10 priority industries for the region – aluminium, glass, steel, oil-based, palm oil, fishing and aquaculture, livestock, timber-based, marine and tourism.

4.5.1 Promoted Areas

Promoted areas are those that are located in the less developed states in Malaysia, most of them are situated in the eastern Peninsular Malaysia and East Malaysia in Borneo. They are less attractive to investors due to their location (far from major ports in Malaysia) and have less infrastructure and fewer facilities than more developed states (located in the western Peninsular Malaysia, which also where the main ports are).[333]

The PIA 1986 provides for several extended tax incentives if promoted activities or promoted products are located in promoted areas, particularly for pioneer statuses and investment tax allowances. These incentives are also available for activities located in other parts of Malaysia, but higher incentives are given if the company is located in promoted areas. The term "promoted areas" has not been specifically defined in PIA 1986 but section 4C gives power to the Minister of International Trade and Industry to determine through gazette orders which areas should be declared as such. The following are five tax expenditures for promoted areas. The tax expenditure analysis for these tax expenditures comes afterwards.

[333] Asan-Ali Golam Hassan, '"Disadvantage Cycle" in the Less Developed States: Evidence from Malaysia' (2007) 14(1) *International Journal of Management Studies* 109, 132.

a. Pioneer Status or Investment Tax Allowance in Promoted Areas

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products, for 5 years; or Investment Tax Allowance of 100% of QCE deductible against 85% of statutory income for 5 years.
Reason(s)	To encourage investments in these states so that they will undergo balanced growth.
Effective Year	- (Incorporated in PIA 1986 when enacted)
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1B), 6(1), 14, 21DA, 26B, 29C
Additional Information	This is enhanced incentive from that granted to the general manufacturing and agricultural sectors in Section 4.4.1.

b. Pioneer Status or Investment Tax Allowance for the Relocation of Manufacturing Activities to Promoted Areas

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products, for 5 years; or Investment Tax Allowance of 100% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	Despite various incentives to attract investment in promoted areas, investments remain low in these areas. This incentive was introduced to reduce the cost of doing business and to attract greater investment, hence helping development in these areas.[334]
Effective Year	2004
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1DE), 6(1AH), 14, 21K, 26L, 29M
Additional Information	Granted to existing companies who relocate their manufacturing activities from outside promoted areas to promoted areas.

[334] *Malaysian Budget Speech 2005*, para 78; Appendix 19

c. Pioneer Status or Investment Tax Allowance for New Investments in 4-Star and 5-Star Hotels in Sabah and Sarawak

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products, for 5 years; or Investment Tax Allowance of 100% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To support the development of Sabah and Sarawak and to promote the tourism industries in these states.[335]
Effective Year	2008
Expiry Year	2013
Source(s)	Announced in 2009 budget speech, but not yet gazetted.[336] However the 2012 budget speech indicated that the allowance is in effect.[337] This allowance is also in effect according to MIDA's website.[338]
Additional Information	This is an enhanced incentive from that granted to the hotel business and tourism industry in Section 4.6.6(a).

[335] *Malaysian Budget Speech 2009,* para 94; Appendix 15.
[336] 2013 Budget Commentary and Tax Information, *A9: Gazetting of 2003 to 2012 Budget Proposals* (MICPA, MIA and CTIM, September 2012) 56.
[337] *Malaysian Budget Speech 2012,* Appendix 6.
[338] MIDA, *Incentives for the Tourism Industry* <http://www.mida.gov.my/env3/index.php?page=tourism-industry>.

d. Infrastructure Allowance

Type	Allowance
Brief Description	Allowance of 100% of QCE incurred on infrastructure, deductible against 100% of statutory income. Any unutilised allowance can be carried forward to subsequent years until fully utilised.
Reason(s)	To attract more investments in the area.[339]
Effective Year	1993
Expiry Year	-
Source(s)	• PIA 1986 ss 41A, 41B
Additional Information	- The word "infrastructure" has been defined by the PIA 1986 as any construction, reconstruction, extension or improvement of any permanent structure including a bridge, jetty, port or road in respect of a business or businesses in operation in a promoted area. - Application for this incentive should be submitted to MIDA.

e. Tax Exemption or Investment Allowance for Approved Service Projects in Promoted Areas

Type	Allowance
Brief Description	Companies involved in Approved Service Projects in promoted areas are entitled for either of these tax expenditures: 1. Tax Exemption under ITA 1967 s 127 – Exemption of 85% of statutory income for 5 years, or 2. Investment Allowance under ITA 1967 sch 7B – Allowance of 80% of QCE deductible against 85% of statutory income for 5 years.
Reason(s)	To modernise the service sector so that they can act as a catalyst for economic development and to explore opportunities to export services.[340]
Effective Year	1995
Expiry Year	-
Source(s)	• ITA 1967 s 127(3)(b), sch 7B • Malaysian Budget Speech 1996 Appendix 10.
Additional Information	This is an enhanced incentive from that granted to the approved services projects in Section 4.10.1(a).

[339] *Malaysian Budget Speech 2006,* para 33; Appendix 4.

[340] *Malaysian Budget Speech 1996* in Malaysia, *Parliamentary Debates*, House of Representatives, 27 October 1995, 43-44 (Anwar Ibrahim).

All of the above tax expenditures are aimed to attract more investment in the promoted areas. The tax expenditures in (a), (c) and (e) above are also available if the promoted activities are undertaken in other parts of Malaysia; however activities undertaken in the promoted areas receive enhanced incentive. Hence, for these three activities, only the increased incentive is regarded as tax expenditures for the promoted areas, while the original incentive is for the promoted products or activities. Pioneer statuses or investment tax allowances for relocation of manufacturing activities to promoted areas is to encourage companies operating in other areas to move their operation to promoted areas. Infrastructure allowance is to attract more construction of infrastructure by businesses in the promoted areas, as infrastructure is one of the key factors in attracting investors.

As have been mentioned before, promoted areas are the less developed areas.[341] The areas receive less investment; hence less development and less employment opportunities. They are not favoured among investors due to factors such as lack of infrastructure and the distance from major ports. The government realises the problem and intervenes in the market to correct the problem. The government is offering these incentives to attract more investors in these areas, so that each state within the country receives equal growth. Nevertheless, the policy to give incentives based on location is not effective.[342] These incentives have been in place for many years and little has been achieved, an indication that the incentives have failed. The allowances and exemptions offered are not sufficiently attractive to encourage more investments in the area. Instead of offering incentives, it is more desirable for the government to look at the reasons behind the lack of investment and development in the promoted areas.

The government is offering infrastructure allowances to companies that built infrastructure in the areas; however, the fact that the companies have to build their own infrastructure is a failure of the government. The government should allocate more to

[341] Hasnah Ali and Sanep Ahmad, 'Why Poor Regions Remain Poor? Evidence from Malaysia' (2009) 5(1) *International Reviews of Business Research Papers* 340, 347-348; Mohammad Sharif Krimi, Zulkornain Yusop and Law Siong Hook, 'Regional Development Disparities in Malaysia' (2010) 6(3) *Journal of American Science* 70, 76-77; Golam Hassan, above n 333, 131.

[342] Golam Hassan, above n 333, 131.

improve infrastructure in these areas, and to provide a better means of transportation for products from the promoted areas to the main ports. Currently the road connecting eastern Peninsular Malaysia to the western Peninsular Malaysia is not in as good condition as the road connecting the north and the south of western Peninsular Malaysia. Similar conditions are present in Sabah and Sarawak, where the road conditions are relatively poor and several areas cannot even be reached by land. Although the road problems are due to the geographical location of these areas, if this is a major reason for the lack of investment, then it is preferable for the government to allocate its resources to improve the road conditions than to lose tax revenue.

Despite the negatives, these areas do have their advantages. They are rich with natural resources, such as oil, gas, timber and specialised crops. The price of land is relatively low compared to the developed states. Labour cost is also cheaper, due to the cheaper cost of living. The government should try to attract investments that could utilise these advantages, for instance from oil and gas companies, labour-intensive companies or manufacturing companies that use locally-sourced raw materials. The current policy that offers incentives based on the same list of promoted products and promoted activities applicable to all areas in Malaysia is incapable of offering targeted government assistance.

If adequate infrastructure and transportation facilities are available, these areas could be as competitive as developed states. However, except for the infrastructure allowance, the other tax expenditures do not correct these drawbacks but simply persuade companies to locate their businesses in promoted areas solely to achieve lower taxable income. Promoted areas could attract more labour-intensive companies due to the lower cost of labour, but they would choose pioneer status over investment tax allowance (because investment tax allowance is offered as a percentage of capital allowance incurred, so is not suitable for labour intensive companies). As discussed in Section 4.3, pioneer status could not be enjoyed if the company is making loss. If the tax expenditures cannot benefit the recipients, they cannot achieve the intended objectives. Hence, it is proposed that these tax expenditures are removed and the government should focus on spending to make improvements on the factors that hinder

investment in these areas. When these issues are resolved, investors should come voluntarily.

4.5.2 Iskandar Malaysia

IM, previously known as the Iskandar Development Region (IDR), is an economic region in the southern part of Peninsular Malaysia launched in 2006 to stimulate economic growth in Malaysia. Given its close proximity to Singapore, it is set to take advantage from the growth of Singapore, since Singapore has limitations on land and labour.[343] Singapore also realised that it can benefit from the strategic partnership with the IM, and have thus become the largest foreign investor in the IM.[344]

There are five tax expenditures offered to support the development of IM. Given IM's vision is to be the first choice for people to "Invest, Work, Live and Play", incentives are given to various relevant sectors to ensure a holistic development of IM. Since all of these tax expenditures have the same objectives, they are analysed together.

Approval to be an IDR-Status company, an IDR Developer and an IDR Development Manager must be obtained from the Iskandar Regional Development Authority, a government statutory body responsible for the management of IM.

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[343] Manu Bhaskaran, 'Iskandar Development Region: A Perspective from Singapore' (Speech delivered at National University of Singapore's Institute of Policy Studies Corporate Associates Breakfast, Singapore, 30 April 2008) <http://spp.nus.edu.sg/ips_stag/Synopsis_CAB_ManuBhaskaran_300408.aspx>; Shibani Mahtani, 'Facing a Space Squeeze, Singapore Looks North', *The Wall Street Journal Asia Edition* (online), 3 October 2012 <http://online.wsj.com/article/SB10000872396390443507204578020912848106062.html>.

[344] Zazali Musa, 'Demand for Industrial Properties on the Rise in Iskandar Malaysia', *The Star* (online), 27 August 2012 <http://biz.thestar.com.my/news/story.asp?file=/2012/8/27/business/11864723&sec=business>.

a. Tax Exemption or Investment Tax Allowance for IDR-Status Companies

Type	Tax exemption/allowance
Brief Description	IDR-Status companies are entitled to either of these tax expenditures: Full tax exemption on income derived from qualifying activity for 10 years; or Investment Tax Allowance of 100% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To attract investments to the area.[345]
Effective Year	2007
Expiry Year	2015
Source(s)	• Income Tax (Exemption) (No. 20) Order 2007 • Application Form for IDR Status Company
Additional Information	- IDR-status companies are resident companies approved by the Ministry of Finance that carry out qualifying activities within IM. Clients are located within IM and outside Malaysia, or all clients are from outside Malaysia. - Qualifying activities are activities related to these 6 service-based sectors: o Creative o Education o Financial advisory and consulting o Healthcare o Logistics o Tourism

[345] Iskandar Regional Development Authority, 'New Flagship Incentives in Iskandar Malaysia and Enhanced Incentive Support Package for the Services Sector' (Press Release, 5 May 2011) <http://www.iskandarmalaysia.com.my/press/new-flagship-incentives-in-iskandar-malaysia-and-enhanced-incentive-support-package-for-the-se>.

b. Tax Exemption for IDR Developers

Type	Tax exemption
Brief Description	Income received by IDR developers from the disposal of rights over land or from the rental or disposal of buildings in IM is 100% exempted from tax. Any unabsorbed losses can be carried forward to future periods until fully utilised.
Reason(s)	To attract investments to the area.
Effective Year	2007
Expiry Year	2015 for disposal of rights over land, 2020 for disposal of buildings
Source(s)	• Income Tax (Exemption) (No. 19) Order 2007
Additional Information	IDR developer refers to an approved resident company which acquires land in IM for development according to the master plan.

c. Tax Exemption for IDR Development Managers

Type	Tax exemption
Brief Description	Income received by IDR development managers from the provision of management, supervisory or marketing services to IDR developer is 100% exempted from tax. Any unabsorbed losses can be carried forward to future periods until fully utilised.
Reason(s)	To attract investments to the area.
Effective Year	2007
Expiry Year	2020
Source(s)	• Income Tax (Exemption) (No. 19) Order 2007
Additional Information	An IDR development manager is a development manager appointed by the IDR developer to provide them with management, supervisory or marketing services.

d. Tax Exemption for Non-Resident Companies on Income Received from IDR-Status Companies/Developers/Development Managers

Type	Tax exemption
Brief Description	Income received by a non-resident person from the following is exempted from tax: 1. Fees for technical advice, assistants or services received from IDR-status company/developer/development manager 2. Interest received from IDR developer 3. Royalty received from IDR-status company/developer
Reason(s)	To attract investments to the area.
Effective Year	2007
Expiry Year	According to the exempt period for IDR-status company/ developer/development manager
Source(s)	• Income Tax (Exemption) (No. 21) Order 2007
Additional Information	-

e. Tax Exemption or Investment Tax Allowance for Tourism, Healthcare and Education Sectors in IM

Type	Tax exemption/allowance
Brief Description	Companies from tourism, healthcare and education sectors are entitled to either of these tax expenditures: Full tax exemption on income derived from qualifying activity for 5 years; or Investment Tax Allowance of 100% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To attract more development projects in these sectors.[346]
Effective Year	2011
Expiry Year	2015
Source(s)	• Flagship Incentives Iskandar Malaysia Infosheet and Guidelines
Additional Information	- Qualifying activities are: o Tourism sector – new investment in hotel or resort projects rated four star and above o Healthcare sector – new Traditional Complementary Medicine centres o Education sector – new private higher education institutions

IM is among the current focus of the Malaysian government, and all the above tax expenditures are offered to attract investment in the region. According to the report, the region has successfully attracted a cumulative investment of MYR 99.79 billion (AUD 33.26 billion) up to September 2012.[347] Based on this, the government claims that the objective to attract investors in the area is a success.

The success could be due to the choice of tax expenditures offered. Most of the tax expenditures are in terms of exemption, which are simpler than allowances. Or, the success could have nothing to do with the tax expenditures but are contributed by other factors such as the excellent infrastructure. Further research is needed to find out what

[346] Iskandar Regional Development Authority, *Flagship Incentives Iskandar Malaysia (FIM) Infosheet and Guidelines* (23 May 2011) <http://www.iskandarmalaysia.com.my/pdf/isc-info-kit/FIM-Infosheet-Guidelines.pdf>.

[347] 'Iskandar Malaysia Nears RM100b Investment Target', *The Star Online*, 9 November 2012 <http://biz.thestar.com.my/news/story.asp?file=/2012/11/9/business/20121109155832&sec=business>.

is causing the success. Information regarding the cost of these tax expenditures is also essential to see how much revenue was lost in order to attain the MYR 99.79 billion (AUD 33.26 billion) investment. If, for example, the cumulative indirect government spending through tax expenditures amounted to MYR 100 billion (AUD 33.3 billion), then the current achievement is actually a failure. Unfortunately, since no data is available, no analysis can be done. This highlights how urgent tax expenditure reporting is in Malaysia.

Will the development of IM fail if no tax exemptions are offered? Based on what happened in the promoted areas, as discussed in Section 4.5.1 above, tax incentives without adequate infrastructure and facilities could not make investment in the areas attractive. In the case of IM, the newly-developed area is equipped with modern infrastructure and facilities. It is also strategically located near Singapore. Hence it can be contended that investors will still invest in IM even in the absence of any tax allowances.

For the purpose of tax expenditure analysis, based on the assumption that these companies need to be assisted by the government, a grant or loan could equally achieve the targeted objectives. The government could manage its resources better with these types of assistance, compared to tax exemptions and allowances, as the amount spent indirectly through these latter methods is hard to obtain and manage. Alternatively, the government resources can be spent to provide stat-of-the-art infrastructure.

In addition, concerns arise that the success of IM has caused the increase in the cost of living and in the cost of real property in the region.[348] As a result, the local residents especially from the low and middle class income groups suffer. This calls for a serious policy review by the government. In any development project, the benefit should flow back to the populace. Although increased cost of living is expected in any development project, the effect should be moderated by the increase in income earned. If this problem is ignored by the government, local residents would sell their property in IM

[348] Nomy Nozwir, 'Chamber Says Johor Malays Poorest Due to Iskandar', *Yahoo! News Malaysia*, 15 January 2013, <http://my.news.yahoo.com/chamber-says-johor-malays-poorest-due-to-iskandar-093831047. html>.

(if they have any) and move to other places. If this happens, IM is going to be occupied by foreign investors, foreign expatriates and Singaporeans looking for bigger accommodation and become a foreign country within a country.

4.5.3 Multimedia Super Corridor

MSC Malaysia was established in 1996 with the goal to become a thriving and dynamic global information and communication technology (ICT) hub that supports the endeavour to achieve Malaysia's Vision 2020.[349] The success of MSC Malaysia depends a lot on MSC status companies. Local and foreign companies are welcomed to apply for MSC status if they develop or use multimedia technologies to produce or enhance their products and services, and for process development. Manufacturing and trading activities are not qualified for MSC status.[350] MSC status companies must place their businesses in the designated MSC cybercities and cybercentres, which are located all over Peninsular Malaysia.[351]

In order to attract companies to invest and later apply for MSC status, the Malaysian government offers promises, known as the Bill of Guarantees, to participating companies. There are 10 guarantees in total, and one to provide competitive financial incentives to MSC status companies. There are only two tax expenditures for MSC Malaysia currently in effect.

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[349] Marika Vicziany and Marlia Puteh, 'Vision 2020, The Multimedia Supercorridor and Malaysian Universities' (Paper presented at the 15th Biennial Conference of the Asian Studies Association of Australia, Canberra, 29 June – 2 July 2004) 3-4.

[350] MSC Malaysia, *How to Apply for MSC Malaysia Status: Non-Qualifying Activities* <http://www.mscmalaysia.my/non_qualify_activities>.

[351] MSC Malaysia, *How to Apply for MSC Malaysia Status: Application Stage* <http://www.mscmalaysia.my/application_stage>.

a. Pioneer Status or Investment Tax Allowance for MSC-Status Companies

Type	Allowance
Brief Description	MSC-Status companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products, for 5 years, with eligibility to extend for another 5 years; or Investment Tax Allowance of 100% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To promote multimedia applications. [352] To accelerate growth of MSC-status companies and enhance the competitiveness of their products and services, which will help realise Malaysia's vision to be a major global ICT hub.[353]
Effective Year	1996
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1A), 6(1AB), 14C, 21C, 26A, 29B • Promotion of Investments (Determination of Assets under section 29B in respect of MSC Status Companies) Order 2001 • MSC Malaysia Bill of Guarantee No. 5
Additional Information	-

The MSC-status companies are granted with Bill of Guarantees, where the government promises 10 privileges to the companies. Apart from the pioneer status and the investment tax allowance, other privileges include exemption from local ownership requirements, unrestricted employment of foreign workers, freedom to finance companies from an overseas source, a promise to be provided with world-class infrastructure and the government's commitment to properly enforce intellectual property protection and cyber laws.[354] The question to be explored is why, with all these advantages, tax allowances are still offered.

[352] *Malaysian Budget Speech 1997,* para 17.

[353] MSC Malaysia, *MSC Malaysia Bill of Guarantees* <http://www.mscmalaysia.my/msc_malaysia_bill_of_guarantees#bog6>.

[354] For full list and explanation on the Bill of Guarantee, see MSC Malaysia, *MSC Malaysia Bill of Guarantees* <http://www.mscmalaysia.my/msc_malaysia_bill_of_guarantees#bog6>.

The reason given by the MSC Malaysia's website is to enhance the competitiveness of the products and services of the MSC companies. By offering the allowance, the companies can reduce the cost of doing business; hence companies can offer products and services to customers at a price lower than other competitors. However, what the government is offering to the MSC companies is only a measure that assists these companies in the short term but does not provide long term competitive advantage. Reduction in price should be due to reduction in operating costs as a result of effective cost management, not due to government assistance.

The MSC Malaysia is built to replicate the California's Silicon Valley in the US; to become the home of technology and multimedia corporations.[355] After more than 15 years of its establishment, MSC Malaysia is claimed as having failed to achieve its vision, although the project itself is, overall, not a failure.[356] Research shows that the failure to achieve its overall vision is due to ineffective implementation, especially on the part of human capital development. The most important factor towards the success of any silicon valley is not government funding or tax incentives, but the people who are involved and their creative and innovative ideas.[357]

Therefore, the government should strengthen other components of the Bill of Guarantees to focus on the development of creative and innovative human capital with entrepreneurial attitudes. Assuming some kind of financial assistance is necessary, it is preferable for the government to provide grants only to companies that have excellent ideas but financial limitations to pursue them.

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[355] Meheroo Jussawalla, 'The Role of Information Technology Parks in Bridging the Digital Divide' in Meheroo Jussawalla and Richard D Taylor (eds*), Information Technology Parks of the Asia Pacific: Lessons for the Regional Digital Divide* (M E Sharpe, 2003) 254, 275.

[356] Danial Hassan, 'Understanding Reasons for Modest Success of Multimedia Super Corridor of Malaysia: A Case for Developing Countries' (2012) 1(3) *Journal of Asian Development Studies* 14, 15.

[357] Jarunee Wonglimpiyarat, 'The Dynamic Economic Engine at Silicon Valley and US Government Programmes in Financing Innovations' (2006) 26 *Technovation* 1081, 1086-10883; Brad Templeton, 'The Real Secret behind Silicon's Valley Success', *Forbes* (online), 7 November 2011 <http://www.forbes.com/sites/singularity/2012/07/11/the-real-secret-behind-silicon-valleys-success/>; 'Mahathir's High-Tech Folly', *Bloomberg Businessweek* (online), 21 March 1999 <http://www.businessweek.com/stories/1999-03-21/mahathirs-high-tech-folly-intl-edition>.

b. Tax Exemption for Non-Resident Companies on Income Received from MSC Status Companies

Type	Tax exemption
Brief Description	Income received by a non-resident company from a MSC status company for the following is exempted from tax: 1. Payment for technical advice or technical services 2. Licensing fees in relation to technology development 3. Interest on loans for technology development
Reason(s)	To encourage foreign assistance in the development of MSC Malaysia
Effective Year	2002
Expiry Year	-
Source(s)	• Income Tax (Exemption) (No. 13) Order 2005
Additional Information	-

If the tax exemption is offered to encourage more non-resident companies to help MSC-status companies, it can be hypothesised that without the tax exemption, the foreign companies do not want to offer their services to MSC-status companies. This claim has no basis. The main concern of any company is making sales; they would sell their products or services to anybody willing to pay for their price. The tax does not concern them as long as they profit from the sales. Hence, with or without the tax exemption, the non-resident companies are going to sell their products or services to MSC-status companies.

Nevertheless, if some kind of assistance is required in this area, it is more justifiable for the government to give financial assistance to the MSC companies to pay for the technical advice or services, licensing fees and interest on loans to the non-resident companies. The same objective could be achieved, and at the same time the cost of the government assistance could be measured and controlled.

4.5.4 North Corridor Economic Region – Tax Exemption or Investment Tax Allowance for Agricultural Projects, Seeds R&D Centres and Premier Industrial Parks within NCER

NCER was launched in 2007 with aims to accelerate economic growth in the areas that form it and to improve the quality of life of these areas' residents.[358] The region focused on five main sectors – agriculture, manufacturing, tourism, logistics and education and human capital initiatives. Various financial, non-financial and fiscal incentives have been announced to attract investments in the region. However, most of the tax incentives offered are the existing incentives for the promoted areas, except for the one illustrated below.

Type	Tax Exemption / Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Exemption of 100% of statutory income for 10 years, starting from the first year of profitability; or Investment Tax Allowance of 100% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To encourage investments within NCER, particularly in the sectors of agriculture, manufacturing, tourism, logistics and education and human capital initiatives.
Effective Year	2007
Expiry Year	-
Source(s)	• NCER website <http://www.koridorutara.com.my/site/?__f=investors_content&id=81>.
Additional Information	-

The offer of tax expenditures indicates that the government is assuming that without tax expenditures the area is not attractive for investments, and that investors in the area need to be assisted to survive in the market. By now, it is an accepted notion that tax expenditures are not key contributing factors in attracting investors,[359] and tax

[358] NCER, *Vision and Mission of NCER* <http://www.koridorutara.com.my/site/?__f=catmain&catname=ncer&catsub=&aliascat=&tracking=&relatedpages=&tracking=0&catsub=&q=ncer/vision_mission>.
[359] Flatters, above n 6, 9.

expenditures are not an effective measure for regional development.[360] The government should concentrate on the development of facilities and infrastructure in the area to make the environment conducive for businesses. Nevertheless, if some companies do need government assistance to survive in the industry, assistance can better target those in need if delivered through grant or loan, with the offered fund tailored to the needs of each company.

4.6 HOTEL AND TOURISM

The tourism industry has become one of the main sources of revenue to Malaysia, particularly through the flow of foreign tourists.[361] Various tax expenditures are offered to support activities that can attract more tourists as well as to encourage better tourism-related facilities.

[360] Golam Hassan, above n 333, 131.

[361] Economic Transformation Programme, *Annual Report 2011* (Malaysia Prime Minister's Department, 2012) 105-106.

4.6.1 Double Deduction for the Promotion of Malaysian Tourism Overseas

Type	Double deduction
Brief Description	Overseas expenses incurred by hotel and tour operators to promote tourism can be deducted twice.
Reason(s)	To increase promotion of tourism overseas. This in return should attract more foreign tourists to come to Malaysia.[362]
Effective Year	1990
Expiry Year	-
Source(s)	• Income Tax (Deductions for Overseas Expenses for Promotion of Tourism) Rules 1991 • Income Tax (Deductions for Overseas Expenses for Promotion of Tourism) (Amendment) Rules 2003
Additional Information	Hotel and tour operating companies are entitled to claim this incentive on revenue expenses incurred: a. For publicity and in the distribution of advertisements in mass media outside Malaysia, b. Through the provision of brochures, magazines and guidebooks for prospective tourists, c. Carrying out market research outside Malaysia, d. Travelling overseas to negotiate or conclude contracts for overseas advertisements or for participation in approved trade fairs, conferences or forums (accommodation expenses are restricted to MYR 300, equivalent to AUD 100, per day, and sustenance expenses are limited to MYR 150, equivalent to AUD 50, per day), e. Organising approved overseas trade fairs, conferences or forums, and f. Maintaining sales offices overseas for the purpose of promoting Malaysian tourism.

The government believes by granting this assistance to hotel and tour-operating companies, the companies will hold more tourism promotion overseas. However, this is an activity that will be undertaken by hotel and tour operating companies whether or not the tax expenditure is available. For companies involved in tourism, if they want to expand their businesses and attract more foreign tourists, overseas promotion is a must. They cannot depend solely on the local market, since the market's small size limits their potential. The promotional costs incurred

[362] *Malaysian Budget Speech 1990* in Malaysia, *Parliamentary Debates*, House of Representatives, 27 October 1989, Appendix 5 (Daim Zainuddin).

can be recovered by incorporating the costs into the sale price. The tax expenditure is irrelevant in their decision to promote Malaysian tourism overseas, although they are certainly happy to enjoy the tax expenditure.

If the double deduction is given to ease hotel and tour operating companies with financial difficulties, then assistance in the form of direct expenditure, such as a grant or loan, is preferable because only companies that are facing difficulties would receive the assistance.

4.6.2 Tax Exemption for Non-Resident Film Companies

Type	Tax exemption
Brief Description	Income received by non-resident companies in Malaysia from filming activities is exempted from income tax.
Reason(s)	To encourage foreign film companies to undertake filming activities in Malaysia. This will promote Malaysia as a tourism destination.
Effective Year	1999
Expiry Year	-
Source(s)	• Income Tax (Exemption) (No. 17) Order 1999
Additional Information	The filming activities have to be approved by Foreign Films Committee under the Ministry of Home Affairs.

The government offers this tax expenditure with the hope that more foreign film companies will come to Malaysia for their filming activities and show to the world through their movies the tourism attractions in Malaysia. Besides the indirect tourism promotion, the country would benefit from employment opportunities among the locals, income from rental of equipment and the transfer of knowledge related to film production.[363] However, further examination is required to find out whether the tax exemption offered is appealing to the non-resident film producers.

[363] National Film Development Corporation Malaysia, *Overview of the Film in Malaysia Incentive* <http://www.filminmalaysia.com/index.php/incentive1>.

It is undeniable that filming activities can boost local tourism industry. An example is the rise in tourism in New Zealand as the result of the The Lord of the Rings film trilogy.[364] However, the main consideration taken into account by film producers is how the location itself fits into the film. Hollywood film producers usually have big budgets and are not greatly persuaded by tax incentives. They are clearly not a needy group. Low budget film producers could possibly need assistance, but since their films generally only reach a smaller audience, the objective to promote tourism is hardly achieved. Therefore, instead of losing tax revenue from non-resident filming activities, it is more desirable for the government to concentrate on promoting Malaysia directly to the film producers.

If converted into direct spending, this tax exemption is equivalent to the government paying the film companies to do their film activities in Malaysia. Whether such a payment is beneficial to a country is hard to determine. In New Zealand, the subsidy paid by the government to The Hobbit's film producer to keep them in New Zealand has been criticised because the movie is using millions of dollars of taxpayer's money despite making huge profits due to its box-office success.[365] The AUD$3 million payment made by Australia for Oprah Winfrey to visit Australia and present the country on her Oprah Winfrey Show has also raised questions, although the government claims that the amount spent has successfully promoted Australia and generated tourism revenue to the country.[366] Nevertheless, payments made by these two countries are one-off payments made only to activities believed to have high potential to attract tourists. On the other hand, Malaysia's tax exemption is made available to any foreign film company, and has been offered since 1999. There is yet to be any film that has had a high

[364] Bronwyn Jewell and Susan McKinnnon, 'Movie Tourism – A New Form of Cultural Landscape?' 24 (2-3) *Journal of Travel and Tourism Marketing* 153, 154.

[365] Ben Child, 'Hobbit Makers Face Call to Return Subsidy Money "Sucked from Kiwi Taxpayers"', *The Guardian* (online), 15 January 2013 <http://www.guardian.co.uk/film/2013/jan/15/hobbit-makers-must-return-money>.

[366] Robert Fenner, James Paton and Nichola Saminather, 'Oprah Stars in Australia's $3 Million Drive for US Tourists', *Bloomberg News* (online), 13 December 2010 <http://www.bloomberg.com/news/2010-12-12/oprah-pats-koala-arrives-in-sydney-in-3-million-push-for-u-s-tourists.html>; Angela Saurine, 'Oprah Effect Pays Off with Rise in US Tourist Visiting Australia', *News Limited Network* (online), 6 December 2012 <http://www.news.com.au/travel/australia/oprah-effect-pays-off-with-rise-in-us-tourist-visiting-australia/story-e6frfq89-1226530747845>.

impact on Malaysia's tourism to anywhere near the extent of The Lord of the Rings' impact in New Zealand. There are a few international films that were filmed in Malaysia, such as Entrapment (featuring Sean Connery and Catherine Zeta-Jones in Petronas Twin Tower), Don (a Bollywood movie featuring Shah Rukh Khan, a very famous Indian actor) and Anna and the King (starring Jodie Foster and Chow-Yun Fat); however the impact they have to Malaysian tourism is unknown. Surprisingly, nobody has questioned this indirect spending. Instead, a new incentive in the form of a cash rebate was recently introduced in 2013 to local and foreign film producers that use Malaysia as the film location or for post-production activities. With this tax expenditure still effective, non-resident film companies can receive double subsidies.

4.6.3 Tax Exemption for Promoters of Car and Motorcycle Races

Type	Tax exemption
Brief Description	Income received from organising car and motorcycle races of international standard held in Malaysia receives 50% tax exemption.
Reason(s)	Car and motorcycle races can be tourist attractions.
Effective Year	1998
Expiry Year	-
Source(s)	• Income Tax (Exemption) (No. 54) Order 2000
Additional Information	The race must be recognised by the Federation Internationale de l'Automobile or the Federation Internationale de Motorcyclisme.

By granting this tax expenditure, the government hopes that as more car and motorcycle races are held in Malaysia, more foreign tourists will come to Malaysia. This can be seen from the terms of the tax exemption that require the races to be "of international standard" to be eligible. The country would benefit from the increased number of tourists through more spending in the country.

Malaysia is already the home to a Formula One Grand Prix race and a Motorcycle Grand Prix race, the Formula One Grand Prix series and Motorcycle Grand Prix series being, respectively, the most prestigious series of car and motorcycle races in the world. Any new races introduced in Malaysia would be a lower standard.

Hence, the tax exemption's real aim is not to attract more car races but to help the current car racing promoters to stay in the business. It is not a coincidence that the tax exemption became effective in 1998, a year before the Formula One racing was first held in Malaysia. Obviously the purpose of this tax expenditure is to help one single company – the promoter of Formula One, which is also the promoter of Motorcycle Grand Prix.

The issue that needs to be pondered is whether the government has a justifiable reason to help the race promoter. The promoter of Formula One, the Sepang International Circuit, has had inconsistent profits reported;[367] but the fact that the company is suffering losses does not justify the need for financial assistance from the government. A loss-making company should apply all managerial strategies to achieve profits, and should not depend on government assistance to survive. There may, nevertheless, be spin-off benefits that justify the subsidy such as the impact of the racing events on tourism in Malaysia. A detailed study is required to determine how much this tax expenditure has cost the government, and how much revenue has been raised by the government from the racing events.

For the purpose of tax expenditure analysis, if the decision to assist the racing promoter can be justified, this tax exemption is not the best form of assistance since it can only be enjoyed if the company is making profit. During losses, the assistance is carried forward to future profitable periods. Given the promoter's reported inconsistent profits, the government intention to help the loss-making promoter cannot be achieved through tax exemption. If the detailed study shows that the racing events have indeed increased government revenue through tourism that would not have happened but for the race and the increased revenue exceeds the cost of the tax expenditure, a cash subsidy would be a more appropriate way of assistance. In addition, there should be an investigation on the company's accounts to identify the reasons for the profit inconsistency. If it is due to inefficient use of resources, then a subsidy is not necessary. Rather, the

[367] On The Road, *Interview with Datuk Razlan Razali – Father, Racer, CEO* (31 July 2012) <http://www.ontheroad.com.my/articles_single.php?pid=1097>.

company's management must be warned that it must improve control over resource utilisation, or it will risk losing the promoter status.

4.6.4 Tax Exemption on Income Attained from the Provision of Chartering Services of Luxury Yachts

Type	Tax exemption
Brief Description	Income received from the provision of chartering services of luxury yachts departing from and arriving at any port in Malaysia is exempted from tax for 5 consecutive years.
Reason(s)	To encourage rental services of luxury yachts and motorboats.[368]
Effective Year	2001
Expiry Year	-
Source(s)	• Income Tax (Exemption) (No. 23) Order 2002
Additional Information	-

One arm of tourism explored by the Malaysian government is yachting tourism. Surrounded by the sea, the government feels like the country should use this strategic location to their economic advantage by encouraging yachting activities. The government wants more companies to offer rental services of luxury yachts. Thus, the government has decided to intervene in the market by offering tax exemptions. However, if this matter were left to the market, there would still be companies that offer the service to meet the demand even without the government incentive. The government intervention in the matter could lead to excess of supply over demand, which ultimately is destructive to the industry.

If this tax expenditure is given as a direct expenditure, the government is subsidising the yacht charters for five years. Why is the subsidy required? The subsidy is not designed to directly attract more tourists. It only acts to help the yacht charters to stay in the business even there are not enough customers to charter the luxury yachts. Hence, it has no effect on Malaysia's tourism industry.

[368] *Malaysian Budget Speech 2002,* para 56.

If there is a valid reason for the government to introduce this tax expenditure, a grant or loan that can offer a targeted assistance is preferable. In addition, this exemption is offered without an expiry date. This is another factor that could lead to the industry's destruction. For tax expenditures introduced to encourage certain types of businesses such as this one, an expiry date is essential for the government to continually assess whether the objective has been achieved. If the number of rental services has reached an adequate level, the exemption should be stopped.

4.6.5 Tax Exemption on Income Attained from Organising Conferences in Malaysia

Type	Tax exemption
Brief Description	Income received from promoting and organising conferences held in Malaysia is exempted from income tax, provided that the conference brought into Malaysia at least 500 foreign participants.
Reason(s)	To attract more foreign tourists to visit Malaysia.[369]
Effective Year	1996
Expiry Year	-
Source(s)	• Income Tax (Exemption) (No. 53) Order 2000
Additional Information	-

The government is offering this tax expenditure to encourage conference organisers to take additional measures to attract at least 500 participants from overseas. It is envisaged that these foreign participants would extend their stay in Malaysia and visit areas across the country. This tax expenditure acts more as a reward for bringing 500 or more foreign participants into Malaysia rather than government assistance. In its equivalent direct expenditure program, the government is granting cash rewards to organisers that have successfully brought 500 foreign participants into Malaysia.

[369] *Malaysian Budget Speech 1997,* paras 40-42; Appendix 4.

To attract foreign participants, the conference must be at an international standard. Besides, the issues to be discussed must be of worldwide interest. Often these conferences are academic conferences, organised by universities or other non-profit organisations. Academic conferences can rarely achieve 500 foreign participants. Besides, these conferences are not profit oriented, so if they do attract 500 foreign visitors, the tax exemption has no significant impact to them.

Therefore, this tax expenditure can be claimed only by a small number of conference organisers and it has no significant impact to Malaysian tourism as a whole. In addition, conference organisers usually target foreign participants to improve the ranking of the conference; tourism is not their concern. Hence, the government should review this tax expenditure, and assess whether it has been fully utilised by conference organisers and, more importantly, whether the goal to attract more foreign tourists has been achieved. It is also interesting to note that when this tax expenditure was announced in 1996 during the 1997 Budget Speech, it was meant to be effective up to the year 2000.[370] Instead, when it was gazetted in 2000, the incentive was made available indefinitely.

Assuming that the decision to reward conference organisers is a sound policy, it is better for the government to offer cash rewards to organisers who have met the target foreign participants of 500 people. By doing this, the non-profit making organisers could also enjoy the benefit and the government could have better control over the expenses.

[370] *Malaysian Budget Speech 1997,* para 42.

4.6.6 Hotel Business and Tourism Industry

The government expects the number of foreign tourists to Malaysia to keep increasing.[371] In order to ensure there are enough hotels to accommodate these tourists, the government is offering pioneer status and investment tax allowances for new players in the industry and existing players that undertake reinvestment activities. The tax expenditure analysis for these allowances is combined together.

a. Pioneer Status or Investment Tax Allowance for the Hotel Business and Tourism Industry

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 70% of statutory income derived from promoted activities or promoted products, for 5 years; or Investment Tax Allowance of 60% of QCE deductible against 70% of statutory income for 5 years.
Reason(s)	To promote Malaysian tourism and to attract more foreign tourists to Malaysia.[372]
Effective Year	1996, with amendments later
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1), 6(1), 14, 21B, 26, 29A. • Promotion of Investments (Promoted Activities and Promoted Products) Order 2012
Additional Information	- Promoted activities for this sector are the: o Establishment of medium and low-cost hotels (up to 3 stars) o Establishment of 4 and 5 star hotels o Expansion or modernization of existing hotels o Establishment, expansion or modernization of tourism projects o Establishment of recreational camps and convention centres - A convention centre must consist of a hall that can accommodate at least 3,000 participants.

[371] 'Malaysia Expects 24mil Tourist Arrivals This Year', *The Star* (online), 2 December 2011 <http://thestar.com.my/news/story.asp?file=/2011/12/2/nation/20111202165450&sec=nation>.
[372] *Malaysian Budget Speech 1997,* paras 40-42; Appendix 4.

b. Pioneer Status or Investment Tax Allowance for Reinvestment in the Hotel Business and Tourism Industry

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 70% of statutory income derived from promoted activities or promoted products, for 5 years; or Investment Tax Allowance of 60% of QCE deductible against 70% of statutory income for 5 years.
Reason(s)	To promote Malaysian tourism and to attract more foreign tourists to Malaysia.[373]
Effective Year	1996, with amendments later
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1DD), 6(1AG), 14C, 21J, 26K, 29L. • Promotion of Investments (Promoted Activities and Promoted Products for Reinvestment) Order 2012
Additional Information	-

Both tax expenditures in (a) and (b) above are intended to encourage companies in the tourism industry to offer adequate facilities to cater for the needs of tourists. They also depict the facilities that are desired by the government. However, the tax expenditure is actually offered for all types of accommodation facilities, from low-cost to five-star hotels, to recreational camps. It can be assumed that the government is offering these incentives because there are an inadequate number of hotels, camps and large convention centres in Malaysia to meet the demand from tourists.

According to the Tourism Malaysia official website, the average occupancy rates for hotels in Malaysia were 59.3 per cent in 2010 and 60.6 per cent in 2011.[374] The rates indicate that the country has enough rooms to accommodate local and foreign tourists.

[373] *Malaysian Budget Speech 1997,* paras 40-42; Appendix 4.

[374] Tourism Malaysia, Average Occupancy Rates (AOR) of Hotels by Locality 2010/2011 (March 2012) <http://corporate.tourism.gov.my/images/research/pdf/2011/AOR/AOR_2010_2011.pdf>.

Hence, no further incentive should be made available. If any hotel thinks that their hotels are popular among tourists and receive above average occupancy rates, they can decide to expand their hotels using their resources, either raised internally or through external loans, in pursuit of higher profits. The government intervention through the tax incentive could lead to over-supply of accommodation facilities, which in turn will force hotel providers to reduce their price and eventually force some of them out of the industry.

If there is a case for the government to help cover capital expenditure incurred, alternative methods of government assistance such as grants or loans is preferable than the tax expenditure programs. The grant or loan would ensure government resources are spent only on companies with financial difficulties. In fact, a grant of this kind is already available under the Tourism Infrastructure Fund offered by the Ministry of Tourism.[375] Hence, the above tax expenditures are redundant. As an alternative to the allowances for reinvestment, the government could also impose regulations to make it compulsory for all hotel providers to make improvements to their facilities after certain periods.

4.6.7 Health Tourism Industry

Malaysia has high potential in the health tourism industry, given the high quality of healthcare services offered, which are at par with those offered by developed countries but at a more reasonable price.[376] There are two tax expenditures offered to support the health tourism industry, and they are analysed together.

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[375] Ministry of Tourism Malaysia, *Tourism Infrastructure Fund* (16 October 2012) <http://www.motour.gov.my/en/ministrys-programme/funds-incentives/tourism-infrastructure-fund.html>.

[376] 'Healthcare Tourism on the Rise', *The Star* (online), 6 September 2012 <http://thestar.com.my/news/story.asp?file=/2012/9/6/nation/20120906204339&sec=nation>.

a. Allowance for Healthcare Service Providers for Services to Foreign Clients

Type	Allowance
Brief Description	Allowance of 100% of value of increased exports deductible against 70% of statutory income for 5 years.
Reason(s)	To promote health tourism industry.[377]
Effective Year	2010
Expiry Year	2014
Source(s)	• Income Tax (Exemption) (No. 6) Order 2009
Additional Information	Foreign clients exclude non-Malaysian citizens who live in Malaysia under the Malaysia My Second Home program, or hold Malaysian student passes and working permits, and their dependents. The definition also excludes non-resident Malaysian citizens living overseas, and their dependents.

b. Allowance for Private Hospitals Involved in Healthcare Travels

Type	Allowance
Brief Description	Allowance of 100% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To further boost the growth of the healthcare travel industry and to encourage private hospitals to expand their capacity and become more export-driven.[378]
Effective Year	2010
Expiry Year	2014
Source(s)	• Income Tax (Exemption) Order 2012
Additional Information	- Projects which qualify for this incentive are: o Any new private healthcare business, and o Any project expanding, modernizing or refurbishing an existing private healthcare facility business. - Applications for this incentive should be submitted to MIDA.

The government is aiming to make Malaysia a preferred health tourism destination.[379] To achieve this, cooperation from the private healthcare providers is essential. Based

[377] *Malaysian Budget Speech 2010,* para 38; Appendix 2.

[378] Bernama, 'Healthcare Travel Industry Gets More Incentives', *The Edge* (Kuala Lumpur), 21 December 2009 <http://www.theedgemalaysia.com/business-news/156076-healthcare-travel-industry-gets-more-incentives.html>.

on the above tax expenditures, there are two tasks that the government wants healthcare providers to undertake – attracting more foreign clients and improving hospital facilities.

These private healthcare providers are doing business. If the government announces it wants to promote health tourism in Malaysia, these hospitals are going to take advantage of the free promotion and marketing undertaken by the government (at no cost to the hospitals) even though no tax allowances are provided. Any increase in cost, either operating costs or those on capital expenditure, incurred to offer state-of-the-art technology could be recovered from the profit they made from the foreign patients. Hence, these tax expenditures are irrelevant in the hospitals' decision to become involved in health tourism.

The allowance for increased exports can also be seen as a government reward for achieving a certain level of foreign clients. However, no government reward is actually required. Increase in sales and profits are rewards that companies are looking for. They would already undertake actions to maximise profits within their resources and capabilities. The tax expenditure offered is irrelevant and a waste of government money.

If there are private healthcare providers that need government assistance to cover the capital expenditure incurred to upgrade the hospital's facilities, the tax expenditure should be substituted with a grant or soft loan. They are transparent and can be easily monitored compared to tax expenditure.

[379] Malaysia Tourism Promotion Board, 'Health Tourism in Malaysia' (Media Release, November 2007) <http://corporate.tourism.gov.my/mediacentre.asp?page=news_desk&subpage=archive&news_id=127>.

4.7 FINANCIAL SERVICES

The financial services sector is one of the 11 sectors in Malaysia's National Key Economic Areas that is expected to significantly contribute to Malaysia's future economic growth. The sector is growing, and constituted an average of 10.9 per cent of the Gross Domestic Product (GDP) in the period between 2006 and 2009.[380] The sector covers both financial institutions and financial markets, which include insurance and banking, capital markets, investment management and venture capital.[381]

4.7.1 Labuan International Business and Financial Centre

Labuan is an island off the Borneo coast. Originally part of the state of Sabah, it was declared as one of the three Malaysian Federal Territories in 1984. The island was designated the Labuan International Offshore Financial Centre since 1990 and has become a tax haven in the Asia Pacific region. It was rebranded the Labuan International Business and Financial Centre (Labuan IBFC) in 2008. One of the significant changes during the rebranding was the removal of the phrase "offshore company", replaced with "Labuan Company". In April 2009 Labuan was blacklisted by the OECD as one of the four "uncooperative tax havens", but was cleared from the list after the Malaysian government agreed to follow OECD standards to chase tax abusers.[382]

To attract more companies to Labuan and to promote Labuan IBFC as a leading financial centre, the government offers special tax treatments for Labuan companies that are involved in a "Labuan business activity".[383] Labuan companies are taxed based on the LBATA 1990, unless they elect to be taxed under ITA 1967. A "Labuan business activity" must be carried in, from or through Labuan in a foreign currency (any

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[380] Performance Management and Delivery Unit, *Economic Transformation Programme: A Roadmap for Malaysia* (Malaysia Prime Minister's Department, 2010) 31.

[381] Performance Management and Delivery Unit, above n 380, 210.

[382] Fintan Ng, 'Malaysia off the OECD Black List', *The Star* (Online), 8 April 2009 <http://biz.thestar.com.my/news/story.asp?file=/2009/4/8/business/3653192&sec=business>; BusinessIFC, *Labuan Removed from OECD Blacklist* (9 April 2009) <http://www.businessifc.com/news/Labuan.htm>.

[383] Labuan companies are governed by Labuan Companies Act 1990, while other companies in Malaysia are governed by Companies Act 1965.

currency other than Malaysian Ringgit) with non-residents or other Labuan entities.[384] There are two types of business activities – trading and non-trading – and the tax regime for Labuan is outlined by these tax activities. Non-trading activity refers to an activity relating to the holding of investments in securities, stock, shares, loans, deposits or any other property by a Labuan entity on its own behalf. Trading activity refers to any activity that is not a non-trading activity, such as banking, insurance, trading, management, licensing and shipping operations.[385] The following are four tax expenditures for Labuan IBFC; the analysis comes afterwards.

a. Preferential Tax Rate of 3% or Fixed Tax of MYR 20,000 for Labuan Trading Activities

Type	Preferential tax rate
Brief Description	A Labuan trading activity company is taxed at the rate of 3% of net profits per audited accounts, or, upon election, could choose a fixed tax of MYR 20,000 (AUD 6,700).
Reason(s)	To make Labuan IBFC a leading financial centre.
Effective Year	1990
Expiry Year	-
Source(s)	• LBATA 1990 ss 4, 7
Additional Information	- A company that carries both trading and non-trading activities is considered as a trading activity company. - Labuan companies (trading and non-trading) can elect to be taxed under the ITA 1967. This election is irrevocable.

[384] LBATA 1990, s 2.
[385] LBATA 1990, s 2.

b. Tax Exemption on Income Attained from Labuan Non-Trading Activities

Type	Tax exemption
Brief Description	A Labuan non-trading activity company is not chargeable to tax.
Reason(s)	To make Labuan IBFC a leading financial centre.
Effective Year	1990
Expiry Year	-
Source(s)	• LBATA 1990 s 9
Additional Information	-

c. Tax Exemption on Income Attained from Qualifying Professional Services in Labuan

Type	Tax exemption
Brief Description	Statutory income derived from the provision of qualifying professional services rendered in Labuan to a Labuan entity receives a 65% tax exemption.
Reason(s)	To further develop Labuan as a financial centre.[386]
Effective Year	2000
Expiry Year	2020
Source(s)	• Income Tax (Exemption) (No. 14) Order 2005 • Income Tax (Exemption) (No. 6) Order 2007 • Income Tax (Exemption) (No. 6) Order 2011
Additional Information	"Qualifying professional services" refers to legal, accounting, financial or secretarial services.

[386] *Malaysian Budget Speech 1997,* para 45; Appendix 7.

d. Global Incentive for Trading Programme for the Labuan International Commodity Trading Company

Type	Preferential tax rate
Brief Description	A Labuan International Commodity Trading company is taxed at the rate of 3% of net profits per audited accounts for the first 5 years. Thereafter, the 3% tax rate is granted if the company fulfilled the specified qualifying criteria. Otherwise, the company is subjected to tax at the rate of 10%.
Reason(s)	Realising how the Oil, Gas and Energy sector could significantly contribute to the growth of Malaysian economy, this tax expenditure aims to attract major international oil trading companies to locate their operations in Malaysia.[387]
Effective Year	2011
Expiry Year	-
Source(s)	• Guidelines by Labuan Financial Services Authority (Labuan FSA) on the Establishment of Labuan International Commodity Trading Company under the Global Incentive for Trading Programme. • Directive on Labuan International Commodity Trading Business. • Labuan Financial Services Authority Act 1996 s 4B.
Additional Information	- A Labuan International Commodity Trading company is the trading of the following commodities in a currency other than Malaysian Ringgit: o Petroleum and petroleum related products o Minerals o Carbon credits o Any other commodities as approved by Labuan FSA - Criteria to qualify for the 3% tax rate are: o a minimum annual turnover of USD100 million, o a minimum annual spending of MYR 3 million (AUD 1 million) payable to Malaysian entities, and o a minimum of three professional traders throughout its operation.

[387] Ahmad Hizzad Baharuddin, 'Programme Launch: Global Incentives for Trading and Labuan International Trading Commodity Company' (Speech delivered at the launch of the Global Incentive for Trading Programme and the introduction of the Labuan International Trading Commodity Company, Labuan FSA, 31 October 2011) <http://www.lfsa.gov.my/c/document_library/get_file?uuid=2593e7f5-00f9-4da6-97f1-b0fb0739785d&groupId=16405>.

According to the OECD, to be considered as a tax haven a jurisdiction must impose 'no or nominal taxes'.[388] The role of tax haven is to allow foreign companies to avoid being taxed in their own country, and pay no or very little tax in the tax haven. Thus, to be a tax haven, the government must offer tax exemption or impose low tax rates to Labuan companies. Without tax exemptions or the low tax rate, Labuan IBFC does not qualify as a tax haven. For this reason, all Labuan tax expenditures should be maintained if the government decides that Labuan should continue to be a tax haven. Whether the government should make such a decision is another matter.

Tax havens are highly criticised for helping foreign companies avoid and evade tax in their home countries. Often this practice is undertaken by companies from developed countries with high tax rates, such as the US. Among methods used by these companies include creating a company based in the tax haven jurisdiction for the purpose of artificial profit shifting through debt shifting, transfer pricing of goods and services and manipulation of the double tax relief.[389] This causes a significant loss of revenue to the companies' home countries.

Another criticism that receives equal concern, and could be more damaging, is the fact that tax havens often promote secrecy of information. The lack of transparency protects tax evaders from investigation by the tax office of their home countries.[390] It could also, however, cause tax havens to become a place used to conceal illegal activities such as money laundering, drug trafficking and terrorism.[391] Labuan's failure to meet standards of transparency is what caused the blacklisting of Labuan by the OECD in 2009 (the blacklisting was removed once Labuan promised to comply).[392]

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[388] OECD, Centre for Tax Policy and Administration, *Tax Haven Criteria* <http://www.oecd.org/ctp/harmfultaxpractices/taxhavencriteria.htm>.

[389] Jane G Gravelle, 'Tax Havens: International Tax Avoidance and Evasion (Congressional Research Service Report for Congress R40623, 23 January 2013) 8-13.

[390] OECD, Harmful Tax Competition: An Emerging Global Issue (OECD Publications, 1998) <http://www.oecd.org/tax/transparency/44430243.pdf> 33.

[391] 'Bank Secrecy Masks a World of Crime and Destruction', *The Guardian* (online), 22 July 2012 <http://www.guardian.co.uk/commentisfree/2012/jul/22/editorial-hsbc-tax-havens-avoidance>.

[392] Chris Giles and Roel Landingin, 'Four on Tax Haven Blacklist Agree to Comply', *The Financial Times* (London), 8 April 2009, 10.

Despite the criticisms, tax havens have flourished. Although tax havens are claimed as having no long term benefits to the tax haven countries,[393] the practice still continues, including in Labuan. There are some perceived benefits of tax havens that governments of tax haven jurisdictions believe will flow into their country. The least is that tax havens earn a share of tax revenue, either directly through corporate tax or indirectly through tax on employees' income, which would not be available if the tax haven does not exist. In addition, companies must pay a fee to operate in tax haven jurisdictions, another source of revenue to the country. However, whether the benefits outweigh the costs to develop, to promote and to manage a tax haven requires further investigation.

The reason given by Mahathir, Malaysia's Prime Minister at that time when he first announced the establishment of Labuan's tax haven, was to attract multinational companies.[394] It is also part of the government's effort to develop the region, economically and socially.[395] Some believed that the Malaysian government wanted to take advantage of the uncertainty of Hong Kong's tax haven status after the scheduled handover to China in 1997.[396] Being a tax haven has certainly benefited Labuan through improved infrastructure. But other benefits, such as job creation, have been insignificant.[397] It is also not clear how much tax revenue has come from Labuan activities. In any case, the Labuan FSA, which recorded fee income as its main source of revenue, suffered a loss of MYR 2.96 million (AUD 1 million) in 2011.[398] Therefore, the Malaysian government should review its decision to make Labuan a tax haven by analysing whether the benefits of imposing very minimal tax offset the overall costs incurred, including the cost of tax expenditures.

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[393] Adam H Rosenzweig, 'Why Are There Tax Havens?' (2010) 52 *William and Mary Law Review* 923, 930.

[394] A Govindasamy, 'Labuan Excited Over Tax Haven Status', *New Straits Times* (Malaysia), 20 November 1989, <http://news.google.com/newspapers?nid=1309&dat=19891120&id=xFlPAAAAIBAJ&sjid=K5ADAAAAIBAJ&pg=2135,1144618> 10.

[395] Dwayne Tan *et al*, 'Labuan as an Offshore Financial Centre' in John J Williams, Lau Sie Ting and Tan Khee Giap (eds), *Business Opportunities in Sarawak, Sabah and Labuan* (Nanyang Business Report Series, 1999) 119, 119; Jason Abbott, 'Treasure Island or Desert Island? Offshore Finance and Economic Development in Small Island Economies: The Case of Labuan' (2000) 18(2) *Development Policy Review* 157, 159.

[396] Jason P Abbott, 'Mahathir, Malaysia and the Labuan International Offshore Financial Centre: Treasure Island, Pet Project or Ghost Town' in Mark P Hampton and Jason P Abbott (eds), *Offshore Finance Centers and Tax Havens: The Rise of Global Capital* (Ichor Business Books, 1999) 192, 194

[397] Jason Abbott, above n 395, 171-172.

[398] Labuan FSA, *Labuan FSA Annual Report 2011*, 78.

4.7.2 Islamic Banking and Finance

Malaysia is one of the top players in today's Islamic banking and financial market. Numerous incentives have been instilled to support the growth of the industry, not only within Malaysia, but also on the international market as Malaysia aims to be the global hub for Islamic finance.[399] There are six tax expenditures to promote Islamic banking and finance in Malaysia and they are analysed together.

a. Double Deduction for the Promotion of Malaysia as an International Islamic Financial Centre

Type	Double deduction
Brief Description	Expenses incurred in the promotion of Malaysia as an international Islamic financial centre can be deducted twice.
Reason(s)	To ensure rapid development in Islamic financial services in Malaysia.[400]
Effective Year	2008
Expiry Year	2015
Source(s)	• Income Tax (Deduction for Promotion of Malaysia International Islamic Financial Centre) Rules 2008 • Income Tax (Deduction for Promotion of Malaysia International Islamic Financial Centre) Rules 2009
Additional Information	Eligible expenses are: a. Market research and feasibility studies; b. Preparation of technical information; c. Participation in a promotion event related to the Global Islamic Finance Forum; d. Overseas travelling expenses for the purpose of any event, including accommodation expenses (limited to MYR 300, equivalent to AUD 100, per day) and sustenance expenses (limited to MYR 150, equivalent to AUD 50, per day); e. Maintenance of an overseas sales office; f. Participation in verified expenses other than in (c) and (d) above; and g. Publicity and advertisements in any media outside Malaysia.

[399] Akmal Hassan, 'Malaysia: A Global Hub for Islamic Finance' (15 June 2011) *Islamic Finance News* 32, 32-33.

[400] *Malaysian Budget Speech 2010,* para 78; Appendix 7.

b. Tax Exemption on Income Received from Islamic Banking and *Takaful*[401] Businesses

Type	Tax exemption
Brief Description	Income received by International Islamic Banks, International *Takaful* Operators and International Currency Business Units from Islamic banking and *takaful* businesses in currencies other than Ringgit, and in "qualifying Ringgit", is exempted from tax for 10 years.
Reason(s)	To make Malaysia a leading international Islamic financial centre.[402]
Effective Year	2007
Expiry Year	2016
Source(s)	• Income Tax (Exemption) (No. 12) Order 2007
Additional Information	- An International Currency Business Unit is a unit within a licensed financial institution that is permitted to conduct a wide range of Islamic banking business in international currencies other than Malaysian Ringgit.[403] - Qualifying Ringgit means investments made in Ringgit that are related and incidental to the carrying out of international currency business. - "Currencies other than Ringgit" do not include currency of the State of Israel.

[401] "*Takaful*" refers to the Islamic-based insurance concept.
[402] *Malaysia Budget Speech 2007,* para 48.
[403] Central Bank of Malaysia, 'Guidelines on the Establishment of International Currency Business Unit' (September 2007) 1.

c. Tax Exemption on Interest Received from Malaysian Non-Ringgit Islamic Securities

Type	Tax exemption
Brief Description	Interest income received from approved Islamic securities originating from Malaysia (other than convertible loan stock) is exempted from income tax.
Reason(s)	To make the securities attractive.
Effective Year	2008
Expiry Year	-
Source(s)	• ITA 1967 sch 6 para 33B
Additional Information	- The securities have to be issued in any currency other than Ringgit Malaysia, and approved by the Securities Commission or LOFSA. - Exemption can be enjoyed by both residents and non-residents.

d. Tax Exemption on Income from the Trading of Non-Ringgit *Sukuk*[404]

Type	Tax exemption
Brief Description	Income received from regulated activities dealing with non-ringgit *sukuk*, or from advising on corporate finance in relation to arranging, underwriting and distribution of non-ringgit *sukuk* that originates from Malaysia, is exempted from tax.
Reason(s)	To promote Malaysia as an international issuance and trading base for non-ringgit *sukuk*.[405]
Effective Year	2009
Expiry Year	2014
Source(s)	• Income Tax (Exemption) (No. 10) Order 2011 • Income Tax (Exemption) (No. 11) Order 2011
Additional Information	The *sukuk* must be issued or guaranteed by the Malaysian government or approved by the Securities Commission.

[404] "*Sukuk*" in the term used for Islamic version of bond.
[405] *Malaysian Budget Speech 2012,* para 26; Appendix 5.

e. Allowance for the Cost of Issuance of Islamic Securities

Type	Allowance
Brief Description	Allowance equivalent to the amount of expenses incurred in the issuance of Islamic securities approved by the Securities Commission or Labuan FSA.
Reason(s)	To promote issuance of Islamic securities and to promote Malaysia as the leading global *sukuk* market.[406]
Effective Year	2003, with amendments later
Expiry Year	2015
Source(s)	• Income Tax (Deduction for Expenditure on Issuance of Islamic Securities) Rules 2005 • Income Tax (Deduction for Expenditure on Issuance of Islamic Securities Pursuant to *Istisna'* Principle) Rules 2005 • Income Tax (Deduction for Expenditure on Issuance of Islamic Securities) Rules 2007 • Income Tax (Deduction for Expenditure on Issuance of Islamic Securities) Rules 2009 • Income Tax (Deduction for Expenditure on Issuance of Islamic Securities) Rules 2011 • Income Tax (Deduction for Expenditure on Issuance of Islamic Securities Pursuant to Principles of *Murabahah* and *Bai' Bithaman Ajil*) Rules 2011
Additional Information	-

By default, the cost of issuance of securities is not deductible for tax purposes because it is not related to income earning activities. The issuance of securities is not trading; thus all associated expenses are generally not deductible. However, this tax expenditure allows the cost of issuance of securities to be deducted as an allowance to promote the Islamic capital market in Malaysia.

The accounting treatment depends on whether the cost is incurred to issue new securities or existing securities.[407] Cost to issue existing securities is to be written off in the income statement. This treatment is similar to the tax rule, thus no tax expenditure arises. Cost incurred to issue new securities is shown in the balance sheet as a deduction from liability. There is no deduction for cost of issuance of

[406] *Malaysian Budget Speech 2003,* para 8; Appendix 14; *Malaysian Budget Speech 2010,* Appendix 9; *Malaysian Budget Speech 2011,* Appendix 1; *Malaysian Budget Speech 2012,* Appendix 4.

[407] IFRS Foundation, *MFRS 132 Financial Instruments: Presentation*, paras 35-37.

securities when computing profits; hence the allowance given by the government is a tax expenditure.

f. Tax Exemption on Fees Received from Managing Islamic Funds

Type	Tax exemption
Brief Description	Fees received for managing approved Islamic funds is exempted from tax.
Reason(s)	To promote Islamic fund management activities, to position Malaysia as the International Islamic Financial Centre.[408]
Effective Year	2007, with amendments later
Expiry Year	2016
Source(s)	• Income Tax (Exemption) (No. 15) Order 2007 • Income Tax (Exemption) (No. 6) Order 2008
Additional Information	- The funds must be approved by the Securities Commission. - Exemption can be enjoyed by both residents and non-residents.

The Islamic financial sector is a booming market. It offers an alternative to the conventional western banking and finance system; attracts investors from the wealthy oil-producing Muslim countries as well as non-Muslim investors who see the benefit of the stability in the system. The goal for Malaysia to be the frontrunner in the Islamic financial market, and to be the leader in global *sukuk* market, could be claimed as a great success. Apart from the numerous tax expenditures offered, the government, as well as private financial institutions, have implemented other measures to support this goal, including improved market regulation, continuous human capital development, and the development of various products which are not constrained only to banking but also include capital market and insurance products.[409]

The double deduction in (a) above is given to boost promotion of Malaysia as the Islamic financial centre, whereas other tax expenditures are intended to make Islamic financial products attractive and to encourage investors to choose Malaysia for their Islamic banking and finance activities. Therefore, the government is assuming that

[408] *Malaysian Budget Speech 2008,* Appendix 10.

[409] Mohd Akram Laldin, 'Islamic Financial System: The Malaysian Experience and the Way Forward' (2008) 24(3) *Humanomics* 217, 223-236; 'Banking on the Ummah: Malaysia Leads the Charge in Islamic Finance' *The Economist* (online), 5 January 2013 <http://www.economist.com/news/finance-and-economics/21569050-malaysia-leads-charge-islamic-finance-banking-ummah>.

without the double deduction, companies are not interested in promoting Malaysia as the Islamic financial centre, and without the other incentives as in (b) to (f), Malaysia's financial products are not attractive and that investors will invest their money in other countries.

The first assumption regarding the double deduction is clearly flawed. Usually when companies offer new products, they take into account promotional expenses. With or without the double deduction, promotional expenses must be incurred. They will pay for promotion regardless, and while promoting their products they promote the Malaysia International Islamic Financial Centre simultaneously. It is possible that, with the double deduction, the government is paying its share for the promotion conducted by the companies.

The second assumption is equally weak. As argued in previous tax expenditure analyses in Sections 4.4 and 4.5, tax expenditure is not a factor considered in investment decisions. Other factors mentioned before (market regulation, human capital and product variation) are more likely to be the main contributors to the success of Malaysia's Islamic financial sector.

If the various tax exemptions do attract investors, other concerns arise. Firstly, the lavish tax expenditures could make Malaysia an unintentional tax haven used by foreign companies to avoid tax in their home countries.[410] Secondly, the claim that Malaysia has successfully become the leader in Islamic finance is misleading due to the unfair competition between Islamic and conventional banking and finance.

Therefore, it is preferable for the government to spend money to improve the market rather than to indirectly spend money through tax expenditures. Of course, further research is needed to determine the success factors of Malaysia's Islamic financial sector. In any case, if tax expenditures should continue to exist, it is a good strategy by the government to offer tax expenditures that expire, so the effectiveness of the tax expenditures can be reviewed.

[410] Jeyapalan Kasipillai and Pak Mei Sen, 'Incentives to Position Malaysia as a Leading Islamic Finance Hub' (2010) 21 *Journal of Banking and Finance Law and Practice* 292, 310.

4.7.3 Tax Exemption on Interest Received by Non-Resident Companies

Type	Tax exemption
Brief Description	Interest income received by non-resident companies from the following is exempted from income tax: • Financial institutions in Malaysia • Approved loans • Government securities • Approved Islamic securities/debentures in Ringgit Malaysia (other than convertible loan stock)
Reason(s)	To extend the domestic capital market[411] and to attract more foreign funds in local financial institutions.[412]
Effective Year	- (Incorporated in ITA 1967 when enacted)
Expiry Year	-
Source(s)	• ITA 1967 sch 6 paras 27, 33, 33A
Additional Information	The exemption on interest received from financial institutions does not apply to interest received from funds required to maintain net-working funds as prescribed by the Central Bank of Malaysia.

Malaysia is a small country. The growth of its financial market is limited if the market is constrained only to local funds. Thus, to attract more foreign investors, the government is offering this tax expenditure based on the belief that without the tax exemption, non-residents are not enticed to Malaysia's financial market. This tax expenditure is available only for non-resident companies to attract more funds in the local financial market. A similar tax expenditure would be less effective when applied to residents because the local financial market is more convenient for them; with or without incentive they will mostly keep their funds locally.

However, the government's assumption has no basis. Tax exemptions are not the factors considered when investing. Normally investors are looking at the balance between risk and return, and these are affected by various factors such as political stability and the country's economy. The group that is attracted to tax exemptions are tax avoiders. Indeed, the tax exemption has the same effect as a tax haven. It helps foreign companies to avoid tax in their home countries. However, unlike

[411] *Malaysian Budget Speech 2005,* Appendix 10.
[412] *Malaysian Budget Speech 2007,* Appendix 21.

Labuan that is declared a tax haven and is excluded from the double tax agreements of a few countries (such as Australia and South Korea),[413] interest income from this investment is included in the treaty and offers a wide opportunity for tax avoidance.

Since no tax expenditure report is available, the revenue lost due to this tax exemption is unknown. Thus, no data is available to show to what extent foreign investors are grabbing this opportunity to avoid tax. This again emphasises the importance of a tax expenditure report.

4.7.4 Tax Exemption on Profits from Overseas New Branches/Investee Companies

Type	Tax exemption
Brief Description	Profits from newly established overseas branches or income from new overseas investee companies by banks, insurance companies and *takaful* companies are exempted from income tax for 5 years.
Reason(s)	Since the banking and insurance sectors are taxed on worldwide income scope, the tax exemption aims to encourage companies from these sectors to expand their operation abroad.[414]
Effective Year	2006, amendment in 2009
Expiry Year	2015
Source(s)	• Income Tax (Exemption) (No. 16) Order 2007 • Income Tax (Exemption) (No. 5) Order 2009 • Income Tax (Exemption) (No. 7) Order 2009
Additional Information	Investee company means at least 20% of the controlling shares are owned by the taxpayer.

The decision to expand operation to overseas involves various considerations. Surely, cost an important factor. However, with the double tax agreements signed between Malaysia and other foreign countries, the impact of double taxation is reduced significantly. Therefore, there is no necessity to offer a tax exemption as an encouragement.

[413] Australian Tax Office, *Australia and Malaysia Treaty – Key Points* (21 December 2007) <http://www.ato.gov.au/businesses/content.aspx?doc=/content/55980.htm>; Kim Jae-won, 'Malaysia Asked to Drop Labuan from Tax Treaty', *The Korea Times* (online), 11 August 2010 <http://www.koreatimes.co.kr/www/news/biz/2010/08/123_71287.html>.

[414] *Malaysian Budget Speech 2007,* Appendix 23; *Malaysian Budget Speech 2010,* Appendix 6.

An alternative view is that the tax exemption is intended as an assistance rather than encouragement. The exemption is given only for the first five years of operation, during which the new branch could perhaps have been unable to make much profit. Hence the government has decided to offer financial assistance. This view, too, has no basis. Banks and insurance companies are traditionally the source of external funding to other companies, and to assume that they need to be funded is a bizarre claim. Banks and insurance companies would require funding only if the parent companies, not the branch, are having financial difficulties. Even then, if they are having financial difficulties, they should not consider expanding overseas. Besides, before deciding to establish overseas branches, usually the companies' management would prepare projected profits and any early year losses are within expectation. Therefore, this tax expenditure has no sound purpose and should be discontinued.

4.7.5 Tax Exemption on Interest Received from Government Savings Certificates

Type	Tax exemption
Brief Description	Interest income received from savings certificates issued by the government is exempted from income tax.
Reason(s)	To make government savings certificates more appealing.
Effective Year	- (Incorporated in ITA 1967 when enacted)
Expiry Year	-
Source(s)	• ITA 1967 sch 6 para 19
Additional Information	Applicable to both residents and non-residents.

Government savings certificates are usually low-risk investments. They are secured by the government and the return is guaranteed. The general rule in investment is the higher the risk, the higher the return. Therefore, government savings certificates are expected to have a lower rate of return. The tax exemption means that the interest rate is actually higher than that stated.

Nevertheless, a higher but taxable interest rate could equally be appealing to investors.

It is also possible that the tax exemption is actually to provide a "short-cut" tax treatment, where instead of the government paying interest and later the recipient pays tax on the interest, the interest is distributed tax-free. It is the equivalent of the government withholding tax on the interest. Whether this incentive is a tax expenditure or just a procedure to ease tax collection depends on the market interest rate for similar low-risk investments. If the interest rate of the government savings certificates is lower due to the implicit tax withheld, then it is not a tax expenditure.

If the interest rate is at par with market interest rate of similar risk, then the tax exemption is a tax expenditure. That also means that it has similar opportunities to attract risk-averse investors. Unless there is separate evidence that says government savings certificates are not favoured among investors, no tax expenditure is necessary.

4.8 THE BALANCE OF PAYMENTS

The balance of payments is a statistical statement that systematically summarises, for a specific time period, the economic transactions of an economy with the rest of the world.[415] It is used by a country to monitor its monetary transactions with other countries. In other words, it shows how much money flows in to and out of a country. Generally this refers to imports and exports of goods and services. Ideally, exports should be greater than imports, or at least be equal. These tax expenditures are the government's efforts to reduce imports and increase exports to achieve a positive balance of payments account. There are nine tax expenditures in total; these tax expenditures are analysed together.

[415] Department of Statistics Malaysia, *Concepts and Definitions* <http://www.statistics.gov.my/portal/index.php?option=com_content&view=article&id=721&lang=en&Itemid=111>; IMF, Balance of Payments Manual (IMF, 5th ed, 1993) 6.

4.8.1 Double Deduction for Insurance Premiums for the Import and Export of Cargo[416]

Type	Double deduction
Brief Description	Insurance premiums paid for the import and export of cargo can be deducted twice if insured with local insurance companies.
Reason(s)	To ensure exporters and importers insure their goods with local insurance companies.[417]
Effective Year	1981 (import) and 1994 (export)
Expiry Year	-
Source(s)	• Income Tax (Deductions of Insurance Premiums for Importers) Rules 1982 • Income Tax (Deductions of Insurance Premiums for Exporters) Rules 1995 • Petroleum (Income Tax) (Deductions of Insurance Premiums for Importers) Rules 1982
Additional Information	Eligible expenses include insurance premiums for the transportation of goods from a factory to an ocean going vessel.[418]

[416] This tax expenditure has been revoked by Income Tax (Deductions of Insurance Premiums for Exporters) (Revocation) Rules 2012 and Income Tax (Deductions of Insurance Premiums for Importers) (Revocation) Rules 2012 effective 2016. It is still included in this thesis because the revocation was gazetted on 19 July 2012, later that the cut-off date for this thesis, which is on 30 June 2012.

[417] *Malaysian Budget Speech 1995* in Malaysia, *Parliamentary Debates*, House of Representatives, 28 October 1994, 6264-6265 (Anwar Ibrahim).

[418] *PJ Sdn Bhd v KPHDN* [2008] MSTC 3,782 (SCIT).

4.8.2 Double Deduction for Export Credit Insurance Premiums

Type	Double deduction
Brief Description	Export credit insurance premiums paid to approved insurance companies can be deducted twice.
Reason(s)	To encourage Malaysian companies to export their products overseas.[419]
Effective Year	1985, with amendments later
Expiry Year	-
Source(s)	• Income Tax (Deductions of Premiums for Export Credit Insurance) Rules 1985 • Income Tax (Deduction for Premium for Export Credit Insurance Based on *Takaful* Concept) Rules 2011
Additional Information	- Credit insurance refers to insurance policies that provide protection on the amount receivable from a company's debtors. In case debtors are unable to pay their debts, the insurance company should recover part of the amount receivable based on an agreed percentage. The export credit insurance provides protection to companies from the risk of bad debts. - In 2011, the incentive was extended to include credit *takaful* insurance taken from approved *takaful* operators to ensure a consistent tax treatment.[420]

4.8.3 Double Deduction for the Promotion of Exports

Type	Double deduction
Brief Description	Expenses incurred to promote exports of Malaysian products can be deducted twice.
Reason(s)	To encourage exports of Malaysian products, hence improving the balance of payments account.
Effective Year	1986, with amendments later
Expiry Year	-
Source(s)	• PIA 1986 s 41 • Income Tax (Promotion of Exports) Rules 1986 • Income Tax (Deduction for Promotion of Exports) Rules 2002 • Income Tax (Deduction for Promotion of Exports) Rules 2007 • IRBM Guidelines and Procedure for Claiming Deductions for Promotion of Exports (2005)

[419] *Malaysian Budget Speech 2011,* Appendix 2.
[420] *Malaysian Budget Speech 2011,* Appendix 2.

4.8.3 Double Deduction for the Promotion of Exports (cont'd)

Additional Information	- Available for all manufacturing, trading and agricultural companies that are seeking opportunities, or are interested in creating or increasing a demand for the export of goods or agricultural produce manufactured, produced, assembled, processed, packed, graded or sorted in Malaysia. - Revenue expenses incurred with regard to the following are entitled for the double deduction. Further explanation is available in the IRBM guidelines. a. Publicity and advertisements in foreign media; b. Free samples to customers outside Malaysia; c. Export market research or information; d. Preparation of tenders for the supply of goods to prospective customers outside Malaysia, other than goods which are normally supplied by the company; e. Overseas travelling expenses to negotiate or conclude contracts, or to participate in trade or industrial fairs and exhibitions, including accommodation expenses (limited to MYR 300, equivalent to AUD 100, per day) and sustenance expenses (limited to MYR 150, equivalent to AUD 50, per day); f. Provision of technical information about the product to potential customers overseas; g. Exhibition in approved trade or industrial fairs and exhibitions; h. Public relation services connected to exports; i. Participation in approved trade or industrial fairs and exhibitions, other than those in (e) and (g) above; j. Cost of maintaining an overseas sales office; k. Professional fees incurred in packing design, provided that goods are of export quality and the company employs local professional service; l. Participation in a virtual trade show; m. Participation in a trade portal; n. Cost of maintaining warehouses overseas; o. Expenses in respect to registration of patents, trademarks and product licensing overseas. - Pioneer companies are also entitled to claim this tax expenditure. Since they received tax exemptions during the pioneer period, the double deduction should be accumulated and claimed after the pioneer period ends.

4.8.4 Double Deduction for the Promotion of Export of Services

Type	Double deduction
Brief Description	Expenses incurred to promote exports of services, professional services and higher education can be deducted twice.
Reason(s)	To promote export of services and to enhance competitiveness of this sector.[421]
Effective Year	1995 (for export of services), 2003 (for export of professional services), with amendments later
Expiry Year	-
Source(s)	• Income Tax (Deduction for Promotion of Export of Services) Rules 1999 • Income Tax (Deduction for Promotion of Export of Services) Rules 2002 • Income Tax (Deduction for Promotion of Export of Services) (Amendment) Rules 2003 • Income Tax (Deduction for Promotion of Export of Services) (Amendment) Rules 2005 • Income Tax (Deduction for Promotion of Export of Services) (Amendment) (No. 2) Rules 2005 • Income Tax (Deduction for Promotion of Export of Professional Services) Rules 2003 • Income Tax (Deduction for Promotion of Export of Professional Services) (Amendment) Rules 2005 • Income Tax (Deduction for Promotion of Export of Higher Education) Rules 2001 • Income Tax (Deduction for Promotion of Export of Higher Education) (Amendment) Rules 2003 • IRBM Guidelines for Claiming Deductions for Promotion of Export of Higher Education (2004)
Additional Information	- This incentive is available for three types of services – general services, professional services and higher education. - The incentive for general services is available for companies, the incentive for higher education is available for all companies that establish, manage and own a registered private higher educational institution, and the incentive for professional services is available to all persons (including sole proprietorship and partnership) that own business in the area of legal, accounting, medical, dental, architectural, engineering and integrated engineering services.

[421] *Malaysian Budget Speech 1996* in Malaysia, *Parliamentary Debates*, House of Representatives, 27 October 1995, Appendix 10 (Anwar Ibrahim).

4.8.4 Double Deduction for the Promotion of Export of Services (cont'd)

Additional Information	- Eligible expenses are: a. Market research; b. Preparation of tenders; c. Preparation of technical information; d. Overseas travelling expenses for the purpose of export, including accommodation expenses (limited to MYR 300, equivalent to AUD 100, per day) and sustenance expenses (limited to MYR 150, equivalent to AUD 50, per day); e. Maintenance of an overseas sales office; f. Publicity and advertisement in any media outside Malaysia; g. Participation in approved trade/industrial/education fairs and exhibitions; h. Feasibility studies for overseas projects identified for the purpose of tender (general services and professional services only); i. Preparation of models for international competition (general services and professional services only).

4.8.5 Double Deduction for Freight Charges on Exports of Rattan and Wood-based Products[422]

Type	Double deduction
Brief Description	Freight charges incurred by manufacturers who export rattan and wood-based products (excluding products from sawn timber and veneer) can be deducted twice.
Reason(s)	To encourage manufacturers in the rattan and wood-based industry to export all or a major portion of their products and become less dependent on primary products, particularly for manufacturers in Sabah and Sarawak.[423]
Effective Year	1990
Expiry Year	-
Source(s)	• Income Tax (Deductions for Freight Charges) Rules 1990.
Additional Information	Eligible freight charges include the freight cost from a factory to an ocean going vessel.[424]

[422] This tax expenditure has been revoked by Income Tax (Deductions for Freight Charges) (Revocation) Rules 2012 effective 2016. It is still included in this thesis because the revocation was gazetted on 19 July 2012, later that the cut-off date for this thesis, which is on 30 June 2012.

[423] *Malaysian Budget Speech 1990* in Malaysia, *Parliamentary Debates*, House of Representatives, 27 October 1989, Appendix 6 (Daim Zainuddin).

[424] *PJ Sdn Bhd v KPHDN* [2008] MSTC 3,782 (SCIT).

4.8.6 Double Deduction for Participation in International Trade Fairs

Type	Double deduction
Brief Description	Double deduction on expenses incurred for participation in approved international trade fairs held in Malaysia.
Reason(s)	Part of the government's effort to encourage more companies to export their products overseas.[425]
Effective Year	1991
Expiry Year	-
Source(s)	• Income Tax (Deductions for Participation in an Approved International Trade Fair) Rules 1991.
Additional Information	The international trade fair and the participating companies must be approved by the Ministry of International Trade and Industry.

4.8.7 Allowances for Increased Exports

Type	Allowance
Brief Description	Various allowances are given to companies involved in manufacturing, agriculture and services based on a certain percentage of "value of increased exports".[426] These can be set off against 70% of statutory income. Any unabsorbed amount is allowed to be carried forward to future periods.
Reason(s)	To encourage companies to increase their exports and hence improve the country's balance of payments accounts.
Effective Year	1998, with amendments later
Expiry Year	-
Source(s)	• Income Tax (Exemption) (No. 12) Order 2002 • Income Tax (Exemption) (Amendment) Order 2003 • Income Tax (Allowance for Increased Exports) Rules 1999 • Income Tax (Allowance for Increased Exports) (Amendments) Rules 2003 • Income Tax (Exemption) (No. 17) Order 2005 • Income Tax (Exemption) Order 2011 • Income Tax (Exemption) (No. 9) Order 2002 • Income Tax (Exemption) (Amendment) Order 2006 • Income Tax (Exemption) (No. 6) Order 2009

[425] *Malaysian Budget Speech 1991* in Malaysia, *Parliamentary Debates*, House of Representatives, 14 December 1990, Appendix 9 (Daim Zainuddin).

[426] "Value of increased exports" means the difference of free on board value of goods and commodities exported in the basis period and that of the immediately preceding basis period.

4.8.7 Allowances for Increased Exports (cont'd)

Additional Information	The summary of the allowances are as follows: - Companies approved as Malaysian International Trading Company, the allowance is 20% of the value of increased exports, for a period of 5 years. - Companies engaged in manufacturing or agriculture that export manufactured products or agricultural produce: o For a manufacturer of export products, different rates of allowance are granted based on the amount of value added[427] by the exported goods: • 30% value added – 10% of the value of increased exports • 50% value added – 15% of the value of increased exports o For an agricultural company that exports agricultural produce, the allowance is 10% of the value of increased exports. o There are also enhanced allowances for these companies if: • They achieve significant increase in exports (value of increased exports at least 50%) – 30% of the value of increased exports • They succeed in penetrating new markets – 50% of the value of increased exports • They achieve the highest increase in exports and receive the Export Excellence Award – 100% of the value of increased exports - Companies engaged in manufacturing of motor vehicles, automobile components and parts: o The rate of allowance depends on the amount of value added, attained by the taxpayer: • 30% value added – 30% of the value of increased exports • 50% value added – 50% of the value of increased exports o This allowance is effective from 2010 until 2014. - Providers of qualifying services:[428] o The rate of the allowance is 50% of the value of increased exports. The services must be provided to foreign clients from Malaysia, with exception to services provided by private healthcare and private education, which can be provided from and in Malaysia. o From 2010 until 2014, private healthcare is entitled to an allowance of 100% of the value of increased exports, if the services are provided to non-Malaysian citizens living outside Malaysia.

[427] The term "value added" refers to the sale price of goods at ex-factory price less the total cost of raw materials.

[428] There are 16 qualifying services – legal, accounting, architecture, marketing, business consultancy, office services, construction management, building management, plantation management, private healthcare, private education, publishing services, information technology and communication services, engineering services, printing services, local franchise services.

4.8.8 Tax Exemption on Income from Organising International Trade Exhibitions in Malaysia

Type	Tax exemption
Brief Description	Income received from organising international trade exhibitions in Malaysia is exempted from income tax if the exhibition brings in at least 500 foreign visitors.
Reason(s)	To ensure exports are continually expanding.[429]
Effective Year	2002
Expiry Year	-
Source(s)	• Income Tax (Exemption) (No. 15) Order 2002
Additional Information	The international tax exhibition needs to be approved by Malaysia External Trade Development Corporation.

4.8.9 Accelerated Capital Allowance for Franchise Fees

Type	Tax deferral
Brief Description	Franchise fee of local franchise brands, which is capital in nature, is deductible in the computation of chargeable income.
Reason(s)	To further develop a local product brand to become strong in the domestic market and accepted in overseas market.[430]
Effective Year	2012
Expiry Year	-
Source(s)	• Income Tax (Deduction for Expenditure on Franchise Fee) Rules 2012
Additional Information	-

A franchise fee is the initial amount payable by a franchisee to a franchisor at the beginning of a franchise business. The payment usually covers the right to use the brand name, plus initial assistance, such as providing training and aiding recruitment and site selection. Referring to MFRS 138 *Intangible Assets*, a franchise fee is an intangible asset, and should thus be amortised over its useful

[429] *Malaysian Budget Speech 2002*, para 61.
[430] *Malaysian Budget Speech 2012*, para 33; Appendix 15.

life and tested for impairment.[431] The government offers a full deduction of any franchise fee as an incentive; therefore it is a tax expenditure in the form of a tax deferral.

It is a common government practice to endeavour to achieve a positive balance of payments account. In fact, most tax expenditures in this chapter focus on the efforts to obtain a positive balance of payments account. The tourism sector aims to attract foreign tourists, the financial sector tries to make itself more attractive to foreign investors, and many incentives are offered to encourage R&D activities so that the country can produce products that can be exported overseas.

The government can only encourage companies to export their products, but it is ultimately up to the companies as to whether or not they will market their products overseas. Entering an overseas market is not an easy task; companies must first ensure their products and services are up to a certain standard and comply with the regulations of the countries they are exporting to. Then, companies need to find customers, and this requires advertising and product promotion. The export process itself incurs more costs, including freight and insurance. All of these efforts involve great determination, and require significant financial resources. However, if companies wish to increase their market penetration and achieve higher sales (and, hence, higher profits), they should be willing to undertake all these efforts without government intervention.

The double deductions for insurance premiums for import and export of cargo in Section 4.8.1 and for export credit insurance premiums in Section 4.8.2 are to encourage exporting companies to insure their goods, and to do so with local insurers. By offering incentives to encourage exporting companies to use local insurers, the government is assuming that the local insurance companies are not able to compete with international insurance companies. If this assumption is true, the solution is for local insurance companies to improve their services and offer competitive prices. The tax incentives could have negative impacts on the local insurance industry because the motivation for improvement is diminished by the availability of the government

[431] Above n 319.

subsidy. In the long run, the local insurers can only survive in the domestic market but cannot expand their services abroad.

Insuring export goods is essential and a normal practice by all exporters in the world. The cost of insurance premiums should be included in the cost of products sold in foreign countries. If the government is subsidising the cost of insurance premiums to reduce the cost of the products to increase their competitiveness in the international market, this means the government is using Malaysian taxpayers' money to subsidise the price paid by international consumers. This is an absurd policy.

Similarly, double deductions for the promotion of exports, freight charges and participation in international trade fairs are incentives offered to encourage companies to undertake activities that are necessary even without any government subsidy. These costs can be recovered by incorporating them in the sale price set for the international market. By no means should the taxpayers' money be used to subsidise foreign consumers. If, due to these costs, local products become pricey and cannot compete in the international market, then the companies must undertake actions to reduce costs or improve product quality so that consumers are willing to pay a higher price.

Allowances for increased exports are given as a reward for achieving certain targets set by the government. However, for companies, their main target is to increase profits. To achieve an increase in exports while at the same time suffering losses is not favoured by shareholders. The reward by the government is unnecessary and irrelevant. Besides, companies normally set their own targets based on their ability and resources. Hence, a separate target set by the government is a redundancy.

The tax exemption for income from organising international trade exhibitions is also a government reward to organisers who have successfully brought in at least 500 foreign visitors into Malaysia. A trade exhibition is a business activity; if the organisers want to maximise profits, they should attract as many foreign visitors as possible. No government reward is necessary – the increased profits are sufficient. To set a target of 500 foreign visitors reduces the organisers' effort to attract any more than 500. Besides, having a certain number of foreign visitors attend a trade exhibition is no

guarantee that exports will increase. The tax expenditure will not achieve its objective if visitors come but decide not to import Malaysian products, say due to a poorly managed exhibition. If an exhibition is in fact poorly managed, the organisers should not be eligible for any reward. Furthermore, this tax expenditure is potentially subject to abuse, since organisers can bring visitors from nearby countries solely to meet the target, without the visitors being in any way interested to import Malaysian products.

The government is offering an accelerated capital allowance for franchise fees of local product brands, where the fee can be fully deducted in the year incurred. In choosing which franchise brand to invest, companies should choose the one with the highest potential to generate the highest profits in the local market. The introduction of a tax expenditure in favour of local brands is a distortion of the market and creates unfair competition between local and international franchise brands. This could, in the long run, reduce competitiveness among local franchise brands and remove the incentive for local brands to improve quality; they can flourish not because they are better than international brands, but because they have access to this tax expenditure.

The government should review the tax expenditures offered to improve the country's balance of payments accounts. The right policy is to help companies enhance their competitiveness in the international market through improving their products and services, not to simply help cover their costs, which in the long run could make them lazy. If there are companies who need financial assistance, they should be assisted through a grant or loan.

4.9 RESEARCH AND DEVELOPMENT

The government always places great emphasis on R&D innovation. Continuous R&D activities are important, especially in the industrial and agricultural sectors, to ensure products reach a certain standard and are constantly improving. This increases competitiveness of local products in the international market as well as the local market, and hence improves the government's balance of payments account by growth in exports and reduction in imports.

MFRS 138 offers a definition for the terms "research" and "development".[432] The term "research" refers to original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding. In contrast, the term "development" refers to the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use. The accounting treatments differ between research expenses and development expenses. Research expenditures are not classified as assets, but are written off immediately when incurred.[433] Development expenditures can only be capitalised as assets if the product or project has potential to be used or sold, and will generate probable economic benefits.[434] Otherwise, development expenditures should be expensed. If it is capitalised as an asset, it should be amortised and tested for impairment.[435]

The PIA 1986 defines R&D as "any systematic or intensive study carried out in the field of science or technology with the object of using the results of the study for the production or improvement of materials, devices, products, produce or processes, but does not include quality control or routine testing of materials, devices, products or produce, research in the social sciences or the humanities, routine data collections, efficiency surveys or management studies, and market research or sales promotions."[436] The ITA 1967 does not provide a definition for R&D, but a set of definitions is available in one of the IRBM public rulings,[437] which is similar to the definition provided by PIA 1986. The tax treatment for R&D expenditures is to deduct them as normal business expenses.

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[432] IFRS Foundation, *MFRS 138 Intangible Assets*, para 8.
[433] IFRS Foundation, *MFRS 138 Intangible Assets*, para 54.
[434] IFRS Foundation, *MFRS 138 Intangible Assets*, para 57.
[435] IFRS Foundation, *MFRS 138 Intangible Assets*, para 74.
[436] PIA 1986, s 2.
[437] Definitions are available in IRBM Public Ruling No 5/2004 Double Deduction Incentive on Research Expenditure, paragraph 6.1. The term "research" is defined as any systematic or intensive study undertaken in the field of science or technology with the object of using the results of the study for the production or improvement of materials, devices, products, produce or processes. The term "research in Information Technology and Software" is defined as any research activity that involves the development of a new technology or enhancement of existing technology through the incorporation of new elements that involve or are expected to result in some advancement of the product, process, device, service, knowledge or understanding relating to IT and its components (hardware, software, etc).

Tax expenditures for R&D have been provided by both ITA 1967 and PIA 1986. They are given in terms of double deductions and allowances. Regardless of whether they are treated as research expenditures or development expenditures in accounting, they deviate from accounting practices. The following tables illustrate the tax expenditures; the analysis comes afterwards.

4.9.1 Double Deduction for Research Expenditure

Type	Double deduction
Brief Description	Eligible research expenditure can be deducted twice.
Reason(s)	To encourage research activities and technological advancement, which are important factors in the development of a nation.[438]
Effective Year	1991, with amendments later
Expiry Year	-
Source(s)	• ITA 1967 ss 34A, 34B • IRBM Public Ruling No 5/2004 Double Deduction Incentive on Research Expenditure • Addendum to IRBM Public Ruling No 5/2004 Double Deduction Incentive on Research Expenditure

Additional Information	- Eligible research expenditures are:
	  - Revenue expenditure incurred on approved research, with exception to companies with pioneer status that choose to deduct its research expenditure after the status ends.
	  - Cash contributions to approved research institutes;
	  - Payment for the use of services of approved research institutes or approved research companies; or
	  - Payment for the use of the services of R&D companies or contract R&D companies.
	- IRBM Public Ruling No 5/2004 and Addendum to IRBM Public Ruling No 5/2004 provide detailed explanation about what should and what should not be considered research expenditure.
	- Research expenditure other than the above is entitled for single deduction[439] and is thus is not considered a tax expenditure.
	- It should be noted that this incentive is available for all types of companies, including those from the services sector.

[438] *Malaysian Budget Speech 1991* in Malaysia, *Parliamentary Debates*, House of Representatives, 14 December 1990, Appendix 11 (Daim Zainuddin).

[439] ITA 1967, s 34(7).

4.9.2 Contract R&D Companies

A 'Contract R&D Company' refers to a company that provides R&D services in Malaysia only to a company other than its related company.[440] Companies that are interested to be involved in R&D activities but lack necessary expertise and facilities can hire the services of a Contract R&D Company to conduct the research for them.

a. Pioneer Status or Investment Tax Allowance for Contract R&D Companies

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products, for 5 years; or Investment Tax Allowance of 100% of QCE deductible against 70% of statutory income for 10 years.
Reason(s)	To further encourage private sector involvement in R&D activities.[441]
Effective Year	1993
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1C), 6(1AC), 14, 21E, 26C, 29D
Additional Information	-

[440] PIA 1986, s 2. The term "related company" refers to a company that controls or is controlled by another company, either directly or indirectly.

[441] *Malaysian Budget Speech 1994* in Malaysia, *Parliamentary Debates*, House of Representatives, 29 October 1993, 7797 (Anwar Ibrahim).

b. Pioneer Status or Investment Tax Allowance for Reinvestment in Contract R&D Companies

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products, for 5 years; or Investment Tax Allowance of 100% of QCE deductible against 70% of statutory income for 5 years.
Reason(s)	To encourage R&D activities.
Effective Year	2003
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1DD)(b), 6(1AG), 14, 21J, 26K, 29L
Additional Information	-

4.9.3 R&D Companies

A 'R&D Company' is defined by the PIA 1986 as a company which provides R&D services in Malaysia to its related company and to any other company.[442] Similar to Contract R&D Companies, a R&D Company conducts research for other companies. But unlike the Contract R&D Company, it can provide research service to its related company.

[442] PIA 1986, s 2.

a. Investment Tax Allowance for R&D Companies

Type	Allowance
Brief Description	Investment Tax Allowance of 100% of QCE deductible against 70% of statutory income for 10 years.
Reason(s)	To further encourage private sector involvement in R&D activities.[443]
Effective Year	1993
Expiry Year	-
Source(s)	• PIA 1986 ss 26D, 29E
Additional Information	-

b. Investment Tax Allowance for Reinvestment in R&D Companies

Type	Allowance
Brief Description	Investment Tax Allowance of 100% of QCE deductible against 70% of statutory income for 10 years.
Reason(s)	To encourage R&D activities.
Effective Year	2003
Expiry Year	-
Source(s)	• PIA 1986 ss 26K, 29L
Additional Information	-

4.9.4 In-House R&D Companies

An in-house R&D company conducts R&D activities for the purposes of its own business.[444] The company must own a research facility and have expertise in the area to undertake the R&D activities.

[443] *Malaysian Budget Speech 1994* in Malaysia, *Parliamentary Debates*, House of Representatives, 29 October 1993, 7797 (Anwar Ibrahim).
[444] PIA 1986, s 2.

a. Investment Tax Allowance for In-House R&D Companies

Type	Allowance
Brief Description	Investment Tax Allowance of 50% of QCE deductible against 70% of statutory income for 10 years.
Reason(s)	To further encourage private sector involvement in R&D activities.[445]
Effective Year	1993
Expiry Year	-
Source(s)	• PIA 1986 ss 26E, 29F
Additional Information	-

b. Investment Tax Allowance for Reinvestment in In-House R&D Companies

Type	Allowance
Brief Description	Investment Tax Allowance of 50% of QCE deductible against 70% of statutory income for 10 years.
Reason(s)	To encourage R&D activities.
Effective Year	2003
Expiry Year	-
Source(s)	• PIA 1986 ss 26K, 29L
Additional Information	-

4.9.5 Commercialisation of R&D Findings

The government continuously supports R&D activities in public research institutes and universities through various grants and schemes; unfortunately the level of commercialisation of the research findings has been very low compared to other developed countries.[446] Consequently, public research institutes and universities have been unable to generate income through the research.

[445] *Malaysian Budget Speech 1994* in Malaysia, *Parliamentary Debates*, House of Representatives, 29 October 1993, 7797 (Anwar Ibrahim).

[446] 'Dons Win Research Awards', *The Star* (online), 11 April 2008 <http://thestar.com.my/news/story.asp?file=/2008/4/11/nation/20912826&sec=nation>.

a. Pioneer Status for Commercialisation of Resource-Based R&D Findings

Type	Allowance
Brief Description	Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products, for 10 years.
Reason(s)	To encourage local companies to engage in the commercialisation of resource-based R&D findings by public research institutes.[447]
Effective Year	2004
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1DF), 6(1AI), 14C, 21L.
Additional Information	-

b. Allowance for Investment in a Project of Commercialisation of Resource-Based R&D Findings

Type	Allowance
Brief Description	Allowance equivalent to the amount invested in the subsidiary company engaged in the commercialisation of R&D findings in resource-based industry.
Reason(s)	To encourage local companies to engage in the commercialisation of resource-based R&D findings by public research institutes.[448]
Effective Year	2004
Expiry Year	-
Source(s)	• Income Tax (Deduction for Investment in a Project of Commercialisation of Research and Development Findings) Rules 2005
Additional Information	Eligible public research institutes are Malaysia's public research institutions and public institutes of higher learning.

The government acknowledges the importance of R&D activities in the development of a nation.[449] The above tax expenditures demonstrate that the government is not only urging companies to become involved in R&D activities themselves, but to support other institutions engaged in R&D activities as well.

[447] *Malaysian Budget Speech 2004,* para 101; Appendix 23.
[448] *Malaysian Budget Speech 2004,* para 101; Appendix 23.
[449] *Malaysian Budget Speech 1991* in Malaysia, *Parliamentary Debates*, House of Representatives, 14 December 1990, Appendix 11 (Daim Zainuddin).

R&D activities usually involve high cost. Except for big companies or industries that are traditionally involved in continuous R&D activities and are already equipped with research facilities, such as pharmaceutical companies, R&D is generally not a favoured business activity. It is a risky investment that does not guarantee profits. Furthermore, there is the possibility that the cost cannot be recovered if the research is unsuccessful and cannot produce new or innovative products. As a result, not many companies are interested in undertaking R&D activities, especially SMEs and those comfortable with their current products.[450] Thus, the government believes it needs to interfere in the market to boost R&D activities among Malaysian companies.

As with other investments, the higher the risk, the higher the expected return. The lack of favour given by companies to R&D activities is perhaps not justified. There are creative and innovative people among the millions of the country's population with fresh ideas to produce new or improved products. The fresh ideas are not motivated by the availability of government incentives; they are purely driven by the desire to improve the population's quality of life. The invention of Microsoft Windows system by Bill Gates and Paul Allen, and the establishment of Apple by Steve Jobs, are perfect examples of how R&D activities can thrive without government subsidies.

Nevertheless, money is needed to turn idea into realisation. While big companies have adequate financial resources to undertake R&D activities, there are market failures that hinder small companies who have ideas to bring the new products into market. In theory, the market should cater for all sectors and there should be lenders to both small and large businesses, with specialist finance firms or private equity firms able to gauge the risks of lending to or investing in smaller businesses with good ideas. In practice, however, there seem to be constraints on small business accessing funding - capital requirements for banks imposed by prudential regulators favour larger institutions and bigger banks find it easier to lend to larger businesses. This is where government assistance is required; to help small start-up companies with no income and restricted capital (usually banks are reluctant to provide loans for new ideas). Assistance with

[450] Ali Salman Saleh and Nelson Oly Ndubisi, 'An Evaluation of SME Development in Malaysia' (2006) 2(1) *International Review of Business Research Papers* 1, 12.

start-up capital is more likely to see new ideas enter the market than assistance with R&D, especially if it is done through the tax system and cannot be accessed by new firms yet to turn a profit.

However, it is an accepted practice among governments around the world to support R&D activities, either through tax expenditures or direct government funding, and Malaysia is right in following suit.[451] Yet, it is crucial to find the best method and design that only targets companies that require assistance and projects that have high potential and will be highly beneficial. With regard to Malaysia's existing R&D tax incentives, although pioneer status and investment tax allowances resemble a grant scheme (they are not automatically available and require companies to go through a detailed application process); they cannot be fully enjoyed by loss making companies in the current period. The double deduction, which offers incentives on revenue expenditure incurred on R&D activities, reduces taxable income. It provides automatic entitlement, but for companies that have inadequate income during the year, the benefit can only be enjoyed in future years. Wealthy companies are not excluded from the benefits, and most probably receive greater benefits from them than small companies as they have more financial resources to incur R&D expenses, and hence, have access to higher incentives.

The current trend among OECD countries is to offer tax incentives along with grants; however, no single design can fit all countries.[452] A thorough study is required to determine the best method to deliver assistance, either through the tax system as tax expenditures, or through direct spending, or both. The best method depends on the country's tax system. If the government decides that the incentive for R&D activities is to be delivered through the tax system, the appropriate targeted beneficiaries must be the SMEs. Bigger companies could be given less generous incentives, but very big companies should not receive any kind of assistance at all (as in Australia).[453] The best

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[451] OECD, *R&D Tax Incentives: Rationale, Design, Evaluation* (November 2010) <http://www.oecd.org/sti/ind/46352862.pdf> 2.

[452] OECD, R&D Tax Incentives, above n 451, 3.

[453] AusIndustry, *R&D Tax Incentive – Fact Sheet* <http://www.ausindustry.gov.au/programs/innovation-rd/RDTaxIncentive/FurtherGuidance,EducationandInformationResources/Pages/RandDTaxIncentive-FactSheet.aspx>; Peter Martin, 'Richest Companies to Lose R&D Tax Incentive', *The Age*

tax incentive design is refundable tax credit, which would be beneficial even for companies that are suffering losses.

4.10 SERVICES

Gradually the services sector has become more important than the manufacturing sector.[454] The government has realised this and responded by providing many tax expenditures to support the sector. The sector covers a wide range, including tourism, financial services and education, which have been put under specific categories in this chapter due to their significance. Manufacturing-related services are included in the manufacturing sector. This section contains tax expenditures for general services and other minor service sub-sectors, namely utilities and ICT, shipping and construction.

4.10.1 Public Utility and Information and Communication Technology

Reliable public utilities and excellent ICT infrastructure are vital to attract more investments in the country. ICT is no longer a luxury, but has joined public utility as a basic need in today's business.

(online), 18 February 2013 <http://www.theage.com.au/opinion/political-news/richest-companies-to-lose-rd-tax-incentive-20130217-2elck.html>.

[454] Ministry of International Trade and Industry Malaysia, *Overview of Services Sector* <http://www.miti.gov.my/cms/content.jsp?id=com.tms.cms.section.Section_ec826083-c0a81573-4df94df9-6b9876b0>.

a. Tax Exemption or Investment Allowance for Approved Service Projects

Type	Allowance
Brief Description	Exemption of 70% of statutory income derived from approved service projects for 5 years; or Allowance of 60% of QCE deductible against 70% of statutory income for 5 years.
Reason(s)	To modernise the services sector so that it can act as a catalyst to economic development and to explore opportunities to export services.[455]
Effective Year	1995
Expiry Year	-
Source(s)	• ITA 1967 s 127(3)(b), sch 7B.

Additional Information	- "Approved service project" means a project in the services sector that relates to transportation, communications, utilities or any other approved sub-sector.
	- Approved Service Projects of strategic and national importance can claim either:
	  o Exemption of 100% of statutory income derived from approved service projects for 10 years; or
	  o Allowance of 100% of QCE deductible against 100% of statutory income for 5 years.
	- The two incentives are mutually exclusive.

Although this tax expenditure is labelled as tax exemption or investment allowance, it is similar to the pioneer status or investment tax allowance offered to manufacturing and agricultural companies. Two mutually exclusive choices are available; one given as a percentage of statutory income, and the other as a percentage of capital expenditure incurred. Therefore the analysis for this tax expenditure is similar to that provided in Section 4.4; the government intervention in this matter could possibly be due to two reasons. The first reason is to assist companies involved in this sector, and the second reason is to partly subsidise the project so that the burden for the high cost is not transferred to consumers. Both reasons, however, are rejected. If the companies are facing financial difficulties, they should apply for a loan. If the tax exemption is intended to keep the price charged to consumers affordable, there is only a small possibility that the price

[455] *Malaysian Budget Speech 1996* in Malaysia, *Parliamentary Debates*, House of Representatives, 27 October 1995, 43-44 (Anwar Ibrahim).

charged to customers is reduced due to this tax expenditure. Therefore, this tax expenditure does not support its objective and is unnecessary government spending.

Assuming there is a case for the government to provide financial assistance, the best method of assistance is to offer a direct expenditure through a grant or soft loan. The government could also provide assistance directly to consumers, where the general public within a certain level of income could be given rebates or concessional prices to help them enjoy these facilities at a lower rate.

b. Accelerated Capital Allowance for ICT Equipment

Type	Tax deferral
Brief Description	Capital allowance of 100% (20% initial allowance and 80% annual allowance) in the first year.
Reason(s)	To encourage the private sector to invest in the latest ICT equipment.[456]
Effective Year	2009
Expiry Year	2013
Source(s)	• Income Tax (Accelerated Capital Allowance) (Information and Communication Technology Equipment) Rules 2008
Additional Information	-

ICT equipment eligible for this tax expenditure includes computers and its components (such as screens, cables, printers and scanners, software systems and network equipment). If the ICT equipment's useful life as used in the calculation of accounting depreciation is more than one year, the accelerated capital allowance that allows the cost of ICT equipment to be fully written off within one year is a tax expenditure. It defers the amount of tax payable to future years.

ICT equipment has shorter useful life compared to other assets since technology changes rapidly and ICT equipment could within a few years become out-dated and obsolete. This requires ICT equipment to be replaced regularly and it could

[456] *Malaysian Budget Speech 2008,* para 86; Appendix 13.

cost a substantial amount of money. However, to be involved in today's business, investment in the latest ICT technology can hardly be avoided. The cost of not investing could be higher due to loss of customers and the potential of being pushed out of the market.

Therefore, it can be argued that companies will invest in the latest ICT equipment without the government incentive. The incentive, in effect, acts as an interest-free loan to lessen the companies' financial burden. Unfortunately, loss-making companies cannot enjoy this benefit as the allowance is carried forward to future periods and can only be deducted once the companies have enough profit. Hence, it is preferable for the government to offer grants or loans to these companies.

c. Accelerated Capital Allowance for Power Quality Equipment

Type	Tax deferral
Brief Description	Capital allowance of 60% (20% initial allowance and 40% annual allowance) in the first year, 40% annual allowance in the second year.
Reason(s)	To help reduce the cost to businesses of interruptions to the power supply.[457]
Effective Year	2006
Expiry Year	-
Source(s)	• Income Tax (Accelerated Capital Allowance) (Power Quality Equipment) Rules 2005
Additional Information	-

Power quality equipment refers to equipment that can help monitor and control the quality of electric power. It helps to prevent damage to machinery and other electrical devices that are sensitive to power quality.[458] The accelerated capital allowance becomes tax expenditure if the asset's useful life for accounting purposes is more than two years.

[457] *Malaysian Budget Speech 2006,* Appendix 20.

[458] Minister of Energy, Green Technology and Water Malaysia, 'Welcoming Speech' (Speech delivered at the Power Quality Symposium, Kuala Lumpur, 13 July 2010 <http://www.kettha.gov.my/en/content/power-quality-symposium-2010>.

The government is offering this incentive to encourage companies to invest in this asset by providing subsidies that act as an interest-free loan to finance the purchase of the equipment. It is also possible that that the government is intervene in the market to highlight the equipment's significance. Similar to the argument used in (b) above, the accelerated capital allowance should simply be converted into a grant or loan to better target the needy groups. However, if it is given as a loan, the loan should be granted only to eligible companies, unlike the accelerated capital allowance, which can be claimed by all companies that purchase the equipment. The selectivity of a loan makes it a preferred method of delivering assistance.

4.10.2 Shipping

The shipping industry is imperative to support the growth of other industries, particularly manufacturing. Given Malaysia's strategic location along the Straits of Malacca, one of the most important shipping lanes in the world that connects the East and the West,[459] the government is giving incentives to ensure competitiveness of Malaysian shipping companies, especially given the rivalry with close-by ports in Singapore, Indonesia and Thailand. There are three tax expenditures available; one for Malaysian ships and two for non-resident companies that offer rental services to local shipping companies. They are detailed below. The tax expenditure analysis follows.

[459] Maritime Institute of Malaysia, *Centre for the Straits of Malacca* <http://www.mima.gov.my/index.php/research-centres/som>; Hans-Dieter Evans and Solvay Gerke, 'The Strategic Importance of the Straits of Malacca for World Trade and Regional Development' (ZEF Working Paper Series No. 17, Centre for Development Research, Department of Political and Cultural Change, University of Bonn, 2006) 4.

a. Tax Exemption for a "Malaysian Ship"

Type	Tax exemption
Brief Description	100% of income received by shipping companies from the operation of a Malaysian ship,[460] through transporting passengers or cargo by sea or letting out on charter a ship on a voyage or time charter basis is exempted from income tax.
Reason(s)	To develop the national shipping industry and reduce the deficit in the balance of payment.[461]
Effective Year	1984, with amendment in 2012
Expiry Year	-
Source(s)	• ITA 1967 s 54A • Income Tax (Exemption) (No. 2) Order 2012
Additional Information	The exemption rate has been reduced to 70% as of 2013.

b. Tax Exemption on Income Attained from the Rental of ISO Containers by Non-Residents

Type	Tax exemption
Brief Description	Income from the rental of International Standard Organisation (ISO) containers (also known as intermodal containers) received by non-residents from shipping companies in Malaysia is exempted from tax.
Reason(s)	To reduce the cost of doing business for shipping companies in Malaysia.[462]
Effective Year	2001
Expiry Year	-
Source(s)	• Income Tax (Exemption) (No. 24) Order 2002
Additional Information	-

[460] "Malaysian ship" means a sea-going ship registered under the *Merchant Shipping Ordinance 1952*, other than a ferry, barge, tug-boat, supply vessel, crew boat, lighter, dredger, fishing boat or other similar vessel.

[461] *Malaysian Budget Speech 2012*, Appendix 10.

[462] *Malaysian Budget Speech 2002,* para 34.

c. Tax Exemption on Income Attained from the Rental of Ships by Non-Residents

Type	Tax exemption
Brief Description	Income received by non-resident companies from the rental of ships under voyage charter, time charter or bare-boat charter to Malaysian shipping companies is exempted from tax.
Reason(s)	To enhance the growth of the national shipping industry.[463]
Effective Year	2006
Expiry Year	-
Source(s)	• Income Tax (Exemption) Order 2007
Additional Information	-

The Malaysian shipping industry is currently under stress as it faces an increase in operating costs, including fuel and compliance costs, fewer demand for its services and a drop in shipping rates, all while the market value of its vessels has diminished significantly.[464] Given its importance to Malaysia's economy, which hugely depends on trading activity with foreign countries, the government feels responsible to provide assistance to ensure the survival of the shipping industry.

Since 1984, 'Malaysian ships' have received full tax exemption. After 27 years, the exemption was reviewed by the government through the Public Finance Reform, one of the measures under the government's Strategic Reform Initiatives that form part of the Economic Transformation Programme.[465] The government contended that in 2008, only six companies out of the total 176 companies benefited from this incentive. As a result, the government moved to reduce the exemption rate to 70 per cent,[466] which was expected to generate MYR 127.8 million (AUD 42.6 million) in tax to the government during its first year of implementation. However, many opposed the change, saying

[463] *Malaysian Budget Speech 2007,* Appendix 35.

[464] Sharidan M Ali, 'Local Shipping Industry Facing Difficulty to Survive under Current Situation, Says Association', *The Star* (Online), 13 August 2012 <http://thestar.com.my/maritime/story.asp?file=/2012/8/13/maritime/11837693&sec=maritime>.

[465] Performance Management and Delivery Unit, *Rationalisation of Corporate Tax Incentives* <http://etp.pemandu.gov.my/Public_Finance_Reform-@-Rationalisation_of_Corporate_Tax_Incentives.aspx>.

[466] ITA 1967, s 54A.

that the move would only cause further hurt to an industry already suffering difficulties.[467] The new rule did not only reduce exemption rate by 30 per cent, but also treated each ship as a different source, and did not permit transfer of losses between different ships.[468] Due to objections from people within the industry, the effective date of the new rule was deferred for a year. It is due to be effective in 2013.

The tax concession that offers full tax exemption to Malaysian ships is a generous tax expenditure. However, it does not promise the success of the Malaysia's shipping industry. An overall evaluation is needed to find the roots of the problems faced by Malaysia's shipping industry. Many problems, such as rising fuel costs and maintenance fees, and decreased shipping rates, are worldwide problems.

The shipping rate is determined by supply and demand.[469] The drop of shipping rate is a result of an oversupply of vessels and decrease in freight demand.[470] This is also a worldwide problem. The oversupply is reported as a result of an increase in the purchase of vessels during the booming period of early 2008. Unfortunately, by the time the vessels were ready to be delivered to the public, the world went through an economic recession that saw a reduction in freight demand. Consequently, not only has shipping rate been reduced, the value of the vessels has also decreased.

Hence, the problems faced by Malaysia's shipping industry are worldwide problems caused by uncontrollable external factors. If the shipping industry is really considered important to the government, some kind of government assistance is required to ensure survival of the industry. However, the government assistance, that is, full tax exemption, is already in place, and problems have still arisen. This supports the claim made by the government that the current incentive only benefits a small number of

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[467] Joint Memorandum by CTIM, MIA and MICPA, *Issues for Post 2012 Budget Dialogue*, 2 April 2012, para 4.1; Sharidan M Ali, 'Tax Woes for Shipping Firms', *The Star* (Online), 11 October 2011 <http://biz.thestar.com.my/news/story.asp?file=/2011/10/11/business/9668057>; Steve Chia, 'Shipping Industry – Sink or Float?' *The Star* (Online), 17 October 2011 <http://thestar.com.my/maritime/story.asp?file=/2011/10/17/maritime/9684197&sec=maritime>.

[468] ITA 1967, s 54A(2).

[469] Peter Lorange, *Shipping Strategy: Innovating for Success* (Cambridge, 2009) 31-35

[470] Keith Bradsher, 'Freighter Oversupply Weighs on Shipowners and Banks', *The New York Times* (online), 25 January 2012 <http://www.nytimes.com/2012/01/26/business/global/the-global-downturn-weighs-on-shipowners-and-european-banks.html?pagewanted=all&_r=0>.

shipping companies. This is unsurprising; since profitable companies can only enjoy the tax exemption, only a few companies can benefit during a crisis like this.

Therefore, this tax exemption should be replaced by a new incentive, offering grants and loans to help cover the rising operating costs. A holistic review is needed to find what kind of assistance is crucial for the survival of the industry, and to find out who needs it. Assistance given by way of direct spending could cater for the individual needs of each company, rather than a blanket tax incentive applicable to all companies but only able to be enjoyed by few.

The other two tax exemptions for the shipping industry are granted to non-resident taxpayers who provide rental services to Malaysian shipping companies. These tax expenditures are not intended to assist the non-resident service providers, but to keep the operating costs of Malaysian shipping companies low. When rental income is exempted from tax, the government is hoping that these non-resident service providers will charge lower rental fees to Malaysian companies and therefore help reduce the companies' operating costs. However, there is no guarantee that the non-resident service providers are going to reduce their rental fee. It is probable that they will charge based on the market price and will themselves reap the benefit of the tax exemption. As such, direct financial assistance to the Malaysian shipping companies could better achieve the objective. The government could finance a certain percentage of the rental cost.

4.10.3 Tax Exemption on Income of Foreign Companies Attained from Trading in Malaysia through Consignees in Specific Commodities

Type	Tax exemption
Brief Description	Income received by non-resident companies from trading in Malaysia through consignees in specific commodities – rubber, copra, pepper, tin, tin ore, gambier, sago flour and cloves – is exempted from tax if these commodities are produced outside Malaysia.
Reason(s)	To encourage foreign commodity traders in agricultural products to use Malaysia as an entrepot trading port.[471]
Effective Year	- (Incorporated in ITA 1967 when enacted)
Expiry Year	-
Source(s)	• ITA 1967 sch 6 para 18
Additional Information	-

Both Malaysia and Singapore have this tax exemption with exactly the same list of commodities. Most probably this tax expenditure is designed to support the role of Singapore as a major entrepot[472] trading port since the colonial British era, together with the other Malaysian port Penang.[473] The government is willing to lose tax revenue in order to benefit from other related activities such as the repacking of products. However, the government should review the relevancy of this tax expenditure to its current economy. These commodities were popular during the colonial era, but some (such as gambier) have lost their importance in today's trading world.

[471] This measure dates from the first Malaysian income tax law and its origins are unclear. However, commentary on an identical measure in the Singapore Income Tax Act (Chapter 134) s 13(1)(n) suggests a rationale similar to that explained in the text. See CCH, *Singapore Master Tax Guide Manual Commentary*, ¶976.

[472] Entrepot is a port where goods for import and export can be stored without paying import duties (source: Cambridge Dictionaries Online).

[473] Wong Lin Ken, 'Singapore: Its Growth as an Entrepot, 1819-1941' (1978) 9(1) *Journal of Southeast Asian Studies* 50, 60; 81-82.

4.10.4 Accelerated Capital Allowance for Mould Used in the Production of Industrialised Building System Components

Type	Tax deferral
Brief Description	Capital allowance of 60% (40% initial allowance and 20% annual allowance) in the first year, 20% annual allowance in the second year and 20% annual allowance in the third year.
Reason(s)	To promote the Industrial Building System as a key construction technique in the industry. The system will enhance the quality of work and reduce labour force.[474]
Effective Year	2006
Expiry Year	-
Source(s)	• Income Tax (Accelerated Capital Allowance) (Mould for the Production of Industrialised System Component) Rules 2006
Additional Information	-

The term "Industrialised Building System" is used in Malaysia to refer to a construction system where components are manufactured either on or off site for later positioning and assembly in constructing a building.[475] In other countries, the system is known as prefabricated construction. The system reduces construction costs, uses fewer workers, improves building quality and reduces construction waste. Despite its advantages, the system is not popular among local construction companies.[476] Hence, the government is offering an accelerated capital allowance to encourage adoption of the system. The accelerated capital allowance is a tax expenditure if the accounting useful life of the mould is more than three years, since part of the tax payable is deferred to future periods.

Research findings indicate that among the reasons for the system's unpopularity are lack of funds, knowledge, training, direction and promotion.[477] However, if the system can reduce construction costs, financial resources should not be a

[474] *Malaysian Budget Speech 2006,* para 89; Appendix 24.

[475] Riduan Yunus, Jay Yang and Eric Too, 'Sustainability Factors in Industrialised Building System' (Paper presented at the World Sustainable Building Conference, Helsinki, 18-21 October 2011) <http://eprints.qut.edu.au/43874/1/SB11_Yunus_Yang_Too_eprint.pdf> 1-2.

[476] Mohd Nasrun Mohd Nawi, A Lee and KM Nor, 'Barriers to the Implementation of the Industrialised Building System (IBS) in Malaysia' (2011) 4 *The Built and Human Environment Review* 22, 25.

[477] Nawi, Lee and Nor, above n 476, 27-32.

problem, apart from the initial cost that may include training and purchase of equipment (such as the mould). Instead of offering an accelerated capital allowance that only benefits profitable companies, it is more appropriate for the government to offer a grant or loan that can be enjoyed by loss-making companies. In addition, the government should provide training to clarify any misunderstandings about the system. Regulations could also be imposed to increase the adoption of the system. This method has already been effective to some degree with the current regulation that requires all construction of Malaysian government projects that cost above MYR 10 million (AUD 3.3 million) to use at least 70% of the system.[478]

4.11 OTHER ECONOMIC AFFAIRS

This segment displays tax expenditures used to support economic affairs that have not been discussed above.

4.11.1 Company (General)

The following are general tax expenditures for companies, not specified to an industry or activity.

[478] Ministry of Finance Malaysia, Treasury Circular Letter No 7/2008 <http://www.treasury.gov.my/pekeliling/spp/spp072008.pdf>.

a. Tax Exemption for Foreign Income

Type	Tax exemption
Brief Description	All foreign sourced income is exempted from tax. Exceptions to this rule are resident companies in the banking, insurance, and sea and air transport sectors.
Reason(s)	To encourage companies to bring income derived from overseas ventures back into Malaysia for investment.[479]
Effective Year	1997
Expiry Year	-
Source(s)	• ITA 1967 sch 6 para 28(1)
Additional Information	-

The general provision of income tax scope for Malaysia, as provided in section 3 of the ITA 1967, is based on a derived and remittance basis, that is, income derived from Malaysia or received in Malaysia from outside is subject to Malaysian income tax. However, schedule 6 of the same Act provides a tax exemption for income remitted into Malaysia.[480] Thus, Malaysia currently applies a territorial tax approach where only income with a Malaysian source is taxed in Malaysia (with exception to companies involved in banking, insurance, and sea and air transportation, as mentioned in Section 2.5.1. These companies are taxed on a worldwide income basis).

The benchmark tax structure developed in Section 3.6 uses worldwide income tax scope as the basis, which means all income earned by residents, whether derived locally or abroad, should be subject to Malaysian income tax. As such, a tax exemption on foreign income is a tax expenditure.

Nevertheless, whether this tax exemption constitutes a tax expenditure depends on the chosen benchmark. If the territorial scope is the benchmark, then no tax expenditure arises. This would mean that foreign income earned by residents is

[479] *Malaysian Budget Speech 1995* in Malaysia, *Parliamentary Debates*, House of Representatives, 28 October 1994, 6260 (Anwar Ibrahim).
[480] ITA 1967, sch 6 para 28(1).

not considered as Malaysian income, and hence should not be taxed. As a result, imposition of tax on foreign income earned by banking, insurance, and sea and air transport companies is a negative tax expenditure. If a derived and remittance approach is selected as the benchmark, a tax expenditure will arise only from foreign income that is remitted into Malaysia, and negative tax expenditure occurs on foreign income earned by banking, insurance, and sea and air transport companies not remitted into Malaysia but still is subject to Malaysian tax.

The issue of the best income tax basis for a country has been widely debated and will not be further discussed in this thesis.[481] The aim of this thesis is to analyse the policy adopted. Since the income is exempted to achieve a certain goal, this thesis focuses on whether the goal is achieved and whether it could better be achieved by direct spending. Under the worldwide income scope benchmark, if this tax exemption was converted into direct spending, it would mean companies would pay tax on their foreign income and later the government would return the tax paid to the companies. The objective to encourage companies to bring their overseas income back to Malaysia for reinvestment is a good one. It creates job opportunities, reduces outflow of cash from the country, lessens dependency on foreign funds and generates future tax revenue for the government in the future. However, the current tax expenditure does not support the objective. Based on its direct spending equivalent, the government has to pay back the amount of tax paid, regardless of whether these companies bring the money back to Malaysia or not.

If the derived and remittance approach is the preferred benchmark, the tax expenditure on income remitted into Malaysia has the effect that the government has to repay tax on the remitted income. This could be the correct policy to achieve the objective; however, more investigation is required to determine

[481] See, for example, J Clifton Fleming, Jr, Robert J Peroni and Stephen E Shay, 'Some Perspectives from the United States on the Worldwide Taxation vs. Territorial Taxation Debate' (2008) 3(2) *Journal of Australasian Tax Teachers Association* 35; Paul R McDaniel, 'Territorial vs. Worldwide International Tax Systems: Which is Better for the U.S.?' (2007) 8(3) *Florida Tax Review* 284; Report of the President's Advisory Panel on Federal Tax Reform, *Simple, Fair and Pro-Growth: Proposals to Fix America's Tax System* (November 2005) 102-105.

whether tax is a factor that hinders the remittance of income into Malaysia. If territorial scope is chosen, this tax exemption could simply escape further investigation. Hence, for the purpose of tax expenditure analysis, territorial scope should not be chosen as the benchmark.

A better approach to encourage reinvestment is to make local investment attractive. The country needs to be politically stable, offer low tax rate, provide supportive policies and regulations with less red tape, encourage continuous human capital development and have excellent state-of-the-art facilities and infrastructure. In addition, the Malaysian market is small; hence the government must provide policies that support exports.

b. Tax Exemption for Capital Gain

Type	Tax exemption
Brief Description	Capital gains are exempted from tax, except for limited cases involving the disposal of a real property, which is taxable under the *Real Property Gains Tax Act 1976*.
Reason(s)	Capital income is not taxable. Only revenue income is taxable.
Effective Year	- (Inherited from UK concepts)
Expiry Year	-
Source(s)	• *CIT v Shaw Wallace & Co* • *Kamakshya Narain Singh v CIT*
Additional Information	-

When income tax was introduced in Malaysia by the British in 1948, there was no CGT. Since then, the absence of a CGT has been accepted as part of the structure of the Malaysian tax system. A sub-form of CGT, known as the RPGT, was introduced effective November 1975.[482] The 'real property' covered by the RPGT includes only land and any assets attached to the land, which includes buildings, trees and minerals, and shares in real property companies.[483] Other capital gains, such as income from disposal of investment, remain not taxable

[482] *Real Property Gains Tax Act 1976*, s 1.
[483] *Real Property Gains Tax Act 1976*, s 2.

under both income tax policy and the RPGT. The tax rate for the RPGT is also lower than the benchmark corporate tax rate. According to the recent 2013 Budget announcement, companies are taxed at the rate of 15 per cent for real property owned less than two years, and 10 per cent if owned between three to five years.[484] Real property owned more than five years is not subject to the RPGT.

The exclusion of capital gains from the Malaysian tax base is not meant to achieve any objective, but is an 'unconscious' policy decision. It was the result of the interpretation of the word "income" by the British judiciary that imposed tax only on revenue receipts (that is, income) and not capital receipts (that is, capital gains).[485] The courts interpreted "income" for tax purposes using the principles of income within trust law, where one category of profits was income for the life beneficiary of a trust and another was capital gain for the remainder beneficiary.[486] While many countries within the British Commonwealth, such as Australia, Canada and South Africa, have moved from this notion and introduced CGT, others, including Malaysia, Singapore, and New Zealand, continue not to have CGT legislation.

Although New Zealand has no CGT, the issue has been reviewed and discussed among the government, politicians and tax scholars.[487] The current decision not

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[484] *Malaysian Budget Speech 2013,* para 132.

[485] *CIT V Shaw Wallace & Co* [1932] 6 ITC 178 (Privy Council); *Kamakshya Narain Singh v CIT* [1943] 11 ITR 513 (Privy Council).

[486] Rick Krever, 'The Ironic Australian Legacy of Eisner v. Macomber' (1990) 7(2) *Australian Tax Forum* 191, 193-194, Richard Krever, 'Interpreting Income Tax Laws in the Common Law World' in Markus Achatz *et al* (eds), *Steuerrecht Verfassungsrecht Europarecht* (Wien: Facultas Verlags- und Buchhandels, 2007) 354, 357-358.

[487] See for example McLeod Committee, *Tax Review 2001 – Final Report* (2001) 26-29 <http://www.treasury.govt.nz/publications/reviews-consultation/taxreview2001/taxreview2001-report.pdf>; Leonard E Burman and David I White, 'Taxing Capital Gains in New Zealand: Assessment and Recommendations' (Paper presented at the Victoria University Tax Working Group Session Three, Wellington, 16 September 2009); Policy Advice Division of the Inland Revenue Department and the New Zealand Treasury, 'The Taxation of Capital Gains' (Paper presented at the Victoria University Tax Working Group Session Three, Wellington, 16 September 2009); Andrew Coleman, 'The Long Term Effects of Capital Gains Taxes in New Zealand' (Working Paper 09-13, Motu Economic and Public Policy Research, August 2009); Daniel Hunt, *Is There a Case for a Comprehensive Capital Gains Tax in New Zealand?* (Masters Thesis, Auckland University of Technology, 2011) <http://aut.researchgateway.ac.nz/bitstream/handle/10292/2306/HuntD.pdf?sequence=5>.

to impose tax on capital gains has been made after considering all relevant factors. On the other hand, Malaysia's policy not to tax capital gains has simply been inherited from an earlier British tax system without further consideration. This thesis proposes that the government should not accept the law as it is but should review the policy and decide what is best for the country.

c. Group Relief

Type	Allowance
Brief Description	70% of adjusted loss from a (surrendering) company can be offset against aggregate income of other related (claimant) companies within the same group.
Reason(s)	To reduce cost of doing business, to strengthen competitiveness and to encourage more investments, especially in high-risk projects.[488]
Effective Year	2006, with amendments later
Expiry Year	-
Source(s)	• ITA 1967 s 44A
Additional Information	Related companies means the surrendering company owns at least 70% of shares in the claimant company, or the claimant company owns at least 70% of shares in the surrendering company, or both surrendering and claimant companies are owned at least 70% by another company. Ownership can be direct or indirect.

The group relief allows intra-group loss transfer between companies within the same group with at least 70 per cent ownership. It is offered to assist companies in doing business, especially to encourage companies to invest in subsidiaries and to undertake high-risk projects that could potentially be unprofitable. Whether this incentive is a tax expenditure or not depends on the benchmark tax unit applied. If the true ability to pay should be measured at the group level, the loss transfer can be part of the benchmark; hence no tax expenditure arises.

If an individual company is the benchmark tax unit, which indicates that company performance and ability to pay is assessed at individual company level, the group

[488] *Malaysian Budget Speech 2006,* para 31; Appendix 1; *Malaysian Budget Speech 2009,* para 85; Appendix 12.

relief is a tax expenditure. In its equivalent direct spending form, the group relief is an interest-free loan given to the claimant company (the company within the same group that takes over the loss company), and the loan is payable by the surrendering company (the loss-making company) when it makes a profit. If the surrendering company does not make any profit and eventually closes down, the loan is converted into a grant.

In the business world, it is normal for a parent company to establish a new subsidiary specialised to undertake a new project or investment. Although they are two different entities, they are related (due to their similar ownership). Like a family, they are expected to help each other. Therefore, if individual company is the benchmark tax unit, this tax expenditure is a justifiable policy. It supports the current way of doing business.

d. Tax Exemption on Income Received from Approved Businesses under the Special Incentive Scheme

Type	Tax exemption
Brief Description	Income received by a resident company that carries a business approved by the Minister of Finance under the special incentive scheme is exempted from income tax. The rate of exemption, the exempt period and other conditions are determined by the Minister.
Reason(s)	To support businesses.
Effective Year	1997
Expiry Year	-
Source(s)	• Income Tax (Exemption) (No.11) Order 2006 • Income Tax (Exemption) (No.12) Order 2006
Additional Information	-

This is a very "open-ended" tax expenditure since the rate of exemption and the exempt period are unspecified and depend to the Minister's approval. Even if a tax expenditure report is prepared, no revenue-forgone measurement can be provided to this tax expenditure due to its uncertain specifications. If this assistance is delivered as a grant, the uncertainty could be justified because the

amount of grant would be subject to the type of business, the type of assistance required and the availability of funds approved for that purpose. However, with the cost hidden, this is a very risky tax expenditure design. This tax expenditure offers a huge opportunity for corruption and abuse of power by officials involved in the approval process. Hence, this tax expenditure should be removed, and if offered through direct spending, its terms should be more specific.

e. Initial Allowance in the Capital Allowance Scheme for General Plant and Machinery and Industrial Buildings

Type	Tax deferral
Brief Description	Initial allowance at the rate of 20% for plant and machinery, and 10% for industrial buildings.
Reason(s)	Inherited from the British capital allowance system.
Effective Year	- (Inherited from UK concepts)
Expiry Year	-
Source(s)	• ITA 1967 sch 3 para 10, 12.
Additional Information	-

Accounting depreciation for fixed assets is a business expense deductible in the calculation of profit. For tax purposes, accounting depreciation is non-allowable; however a similar scheme known as capital allowance (the term used in Malaysia for capital depreciation or tax depreciation) has been introduced as a replacement. Although the concepts are similar, they two serve different purposes. The objective of accounting depreciation is to allocate the cost of an asset throughout its useful life,[489] whereas the tax capital allowance is given to reflect the reduction in the asset's value caused by natural process of decay or exhaustion by use.[490]

The accounting standard does not specify the useful life for any type of asset. The estimation of an asset's useful life is a matter of judgment based on the

[489] IFRS Foundation, *Basis for Conclusions on MFRS 116 Property, Plant and Equipment*, para BC29.
[490] CCH, *Malaysia Master Tax Guide Manual Commentary* (at 6 June 2012) ¶1300.

company's experience with similar assets.[491] In addition, the useful life should be regularly reviewed.[492] The standard also does not stipulate which depreciation method should be used. Whether it be the straight line method, the diminishing balance method or the units of production method, the correct method shall reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.[493]

In contrast, the tax capital allowance scheme for general plant, machinery and industrial buildings requires the use of the straight line method with specified rates. The rates differ between different types of assets. There are two components of capital allowance – initial allowance and annual allowance. Initial allowance is given only in the first year of claim, on top of the annual allowance that is provided every year, so long as the asset is in use until the cost is fully claimed.

Whether the annual allowance is a tax expenditure or not depends on the asset's accounting depreciation. If the accounting depreciation uses the straight line method at the same rate as the capital allowance, then no tax expenditures or negative tax expenditures arises. If the rate or the method used causes the annual allowance to be greater than the accounting depreciation, it is a tax expenditure. If the annual allowance is lesser, it is a negative tax expenditure.

Initial allowance is a tax expenditure because it results in higher capital allowance being deducted in the first useful life of the asset. This causes income to be deferred to future periods. In addition, the strict eligibility to claim capital allowance, including the narrow definition of assets and expenses that qualify for it, makes it a negative tax expenditure. This matter is further discussed in Section 6.3.1.

[491] IFRS Foundation, *MFRS 116 Property, Plant and Equipment*, para 57.
[492] IFRS Foundation, *MFRS 116 Property, Plant and Equipment*, para 51.
[493] IFRS Foundation, *MFRS 116 Property, Plant and Equipment*, paras 60-62.

The initial allowance in Malaysia's capital allowance system is inherited from the British tax system, in which it was introduced to encourage investment in new assets. However, in the 1984 tax reforms, the initial allowance was removed from the capital allowance regime. The change made the regime more like accounting depreciation.[494] On the other hand, initial allowance in the Malaysian tax system is not specific to new assets only. Thus it does not serve the same purpose as Britain's initial allowance. Its real purpose is vague. The government should review the current capital allowance system to reflect its overall objectives.

4.11.2 Small and Medium Enterprises

SMEs have a huge impact on the local economy. A report published in 2011 reveals that SMEs contribute 32.5 per cent of Malaysia's GDP, an increase of 3.1 per cent from 2005.[495] The growth of SMEs is higher than the nation's overall economic growth, where SMEs growth rate is 6.8 per cent while overall economic growth is 5.1 per cent. SMEs also contributed to 57.3 per cent of the total employment in 2011.[496] Due to their importance, the government acts to assist the further development of SMEs, by offering grants and loans and various tax incentives, and providing coaching and training. Below is a list of tax expenditures offered to all SMEs, and enhanced tax expenditures for SMEs meant for promoted activities or promoted products.

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[494] HM Revenue and Customs, *CA10040 – History of Capital Allowances* <http://www.hmrc.gov.uk/manuals/camanual/ca10040.htm>.

[495] Department of Statistics Malaysia, 'Census Report on SEMs 2011' (Press Release, 18 September 2012) <http://www.statistics.gov.my/portal/images/stories/files/LatestReleases/BE/BI/BE2011_SMEsBI.pdf>.

[496] National SME Development Council, *SME Annual Report 2011/12*, 20-21.

a. Preferential Tax Rate for SMEs

Type	Preferential tax rate
Brief Description	Small and medium companies with paid up capital not exceeding MYR 2.5 million (AUD 833,000) are taxed at 20% for the first MYR 500,000 (AUD 167,000) of chargeable income. Income that exceeds MYR 500,000 (AUD 167,000) is subject to the normal corporate tax rate of 25%.
Reason(s)	To support the development of SMEs and to promote investment by local companies.[497]
Effective Year	2003, with amendments later
Expiry Year	-
Source(s)	• ITA 1967 sch 1 paras 2A-2B
Additional Information	To be eligible, SMEs must not be controlled by another company that have paid up capital of more than MYR 2.5 million (AUD 833,000).

The preferential tax rate of 20 per cent for the first MYR 500,000 (AUD 167,000) of income is a tax expenditure because the tax rate is lower than the benchmark tax rate of 25 per cent. However, if the benchmark acknowledges SMEs as a different taxpayer group that is entitled to a lower tax rate, as in the case of an individual's progressive tax rate, this preferential tax rate is considered part of the benchmark.

Generally, under the ability-to-pay principle, SMEs are a needy group that should receive government assistance. As noted in the previous paragraph, the preferential tax rate applies the same principle used in the progressive tax rate applicable for individuals. This means SMEs with a lower capability to pay income tax are charged with a lower tax rate. Therefore, this tax expenditure is a justifiable policy to uphold the concept of fairness and ability-to-pay in taxation.

However, if the preferential tax rate is viewed as assistance to SMEs, then direct expenditure is a better way to help this group since loss-making companies cannot enjoy a preferential tax rate as they have no income to be taxed.

[497] *Malaysian Budget Speech 2003,* Appendix 1.

b. Pioneer Status or Investment Tax Allowance for Small Scale Companies

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products, for 5 years; or Investment Tax Allowance of 60% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To provide support for small scale companies.
Effective Year	2003
Expiry Year	-
Source(s)	• PIA 1986 ss 5(1), 6(1A), 14, 21BA, 27(1A), 29AA. • Promotion of Investments (Promoted Activities and Promoted Products for Small Scale Companies) Order 2012. • MIDA's Guidelines on Definition of Small Scale Company under the Promotion of Investment Act, 1986 and Criteria for the Granting of Tax Incentives.
Additional Information	- "Small scale companies" refers to companies incorporated in Malaysia with a shareholders' fund not exceeding MYR 2.5 million (AUD 833,000) and having at least 60% Malaysian equity (if the shareholders' fund does not exceed MYR 500,000, equivalent to AUD 167,000) or 100% Malaysian equity (if the shareholders' fund is above MYR 500,000, equivalent to AUD 167,000). - Promoted activities and promoted products for small scale companies are determined by gazette orders. They generally include manufacturing and agricultural activities regarding specified products.

This tax expenditure is similar to the pioneer status or investment tax allowance for the manufacturing and agricultural sectors provided in Section 4.4, but this one can only be enjoyed by SMEs. SMEs are eligible to claim both, so have wider access to pioneer status or investment tax allowance.

The government feels that SMEs need to be assisted and offers assistance by way of the tax system apart from the various grants and loans available through

various government agencies. The allowances are available only for certain products or activities within the manufacturing and agricultural sectors, which help to focus the targeted beneficiaries. However, the design of the tax expenditure has flaws, such as the fact that it benefits profitable companies more than loss-making companies and its costs are hidden. The refundable tax credit is the best design to funnel government assistance through the tax system. Companies with no income can enjoy refundable tax credit through the refund facility, and its cost is quantifiable. In addition, it can increase tax compliance among SMEs as they need to lodge tax return forms to receive the incentive.

c. Accelerated Capital Allowance for the Registration of Patents and Trademarks

Type	Tax deferral
Brief Description	The amount incurred to register patents and trademarks in Malaysia by SMEs, which are capital in nature, is deductible in the computation of chargeable income.
Reason(s)	To promote innovation and intellectual property development among SMEs.[498]
Effective Year	2010
Expiry Year	2014
Source(s)	• Income Tax (Deduction for Expenditure on Registration of Patent and Trade Mark) Rules 2009
Additional Information	Eligible companies are: - Companies with paid up capital of not more than MYR 2.5 million (AUD 833,000) and not related to other companies with paid up capital of MYR 2.5 million (AUD 833,000) or more. - Manufacturing, manufacturing-related and agro-based companies that have no more than 150 full-time employees and generate sales no more than MYR 25 million (AUD 8.3 million). - Service, primary agriculture, and ICT companies that have no more than 150 full-time employees and have sales no more than MYR 5 million (AUD 1.7 million).

In accounting, the costs of registering of patents and trademarks should be amortised over the patents' and trademarks' useful lives.[499] Under the Malaysian

[498] *Malaysian Budget Speech 2010,* Appendix 1.

law, the useful life of patent is 20 years, and the useful life of trademark is 10 years.[500] Since tax law allows this cost to be fully deducted immediately in the year incurred, there is a tax deferral, which is a tax expenditure.

A separate accelerated capital allowance for registration of patents and trademarks is already available for manufacturing companies, as can be seen in Section 4.4.17, where the cost can be written off over a period of five years. This accelerated capital allowance, available only for SMEs, offers a higher tax expenditure since the cost can be fully deducted in the first year. It is perhaps because the companies are regarded as having limited funds that the government has decided to offer an enhanced tax expenditure.

The goal to promote intellectual property development is important given that intellectual property awareness among Malaysian companies is still low.[501] Patent and trademark fees are costly, mainly because registration is made up of several, particularly legal, processes. Thus, financial assistance is necessary, especially for new companies in business with restricted financial resources. It is not appropriate for the government to partly subsidise the registration cost to make it cheaper, since all companies, including those with massive financial resources, will receive the subsidy. The best method to achieve the goal, which aims only at companies with limited financial ability, is by providing a grant or loan offered only to this group.

4.11.3 Oil and Gas

Oil and gas are scarce resources. Demand keeps increasing, but supply is controlled since its levels are finite. Most oil-producing countries, including Malaysia, are dependent on oil and gas as their main source of government revenue. Only one tax expenditure has been identified in this thesis.

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[499] IFRS Foundation, *MFRS 138 Intangible Assets*, paras 74-75.
[500] *Trade Marks Act 1976*, s 32(1) and *Patents Act 1983*, s 35(1).
[501] 'IP Protection Awareness Still Low, Says MyIPO', *Bernama* (Malaysia) 14 January 2013.

a. Preferential Tax Rate for Petroleum Operations in the Joint Development Area

Type	Preferential tax rate
Brief Description	Companies undertaking petroleum operations in the Malaysia-Thailand Joint Development Area are taxed at 0% for the first 8 years of production, 10% for the next 7 years and 20% for subsequent years.
Reason(s)	To attract more Malaysian companies to undertake petroleum operations in the area.
Effective Year	1995
Expiry Year	-
Source(s)	• PITA 1967 s 23(2) • The Protocol to the Malaysia-Thailand Double Tax Agreement, Article 7A (2)[502]
Additional Information	"Petroleum operations" refers to searching for, and winning or obtaining petroleum by any drilling, mining, extracting or other like operations or processes, and any sale or disposal of petroleum (including transportation costs within Malaysia), and in the case of Petroliam Nasional Berhad (Petronas),[503] any sale or disposal of petroleum within Malaysia of petroleum obtained from outside Malaysia (including transportation costs within Malaysia).[504]

Following overlapping claims over a continental shelf rich in natural resources (oil and gas) by Malaysia and Thailand, a Memorandum of Understanding was signed in 1979 between the two governments to create Malaysia-Thailand Joint Development Area. Both countries agreed to jointly explore and exploit the area, and share the benefits equally.[505] As such, all revenue from petroleum operations in the area, which include royalties and taxes, are shared. In other words, contractors have to pay royalties, profits and taxes to both Malaysia and Thailand.

[502] The protocol can be viewed at <http://download.rd.go.th/fileadmin/download/nation/Malaysia 251151 _e.pdf>.

[503] Petronas is a wholly-owned Malaysian government oil and gas company and has entire ownership and control of Malaysia's oil and gas resources. All companies that want to undertake petroleum operations in Malaysia must do so through production sharing contract with Petronas. For further information regarding Petronas see Petronas, *Corporate Profile* <http://www.petronas.com.my/about-us/Pages/corporate-profile.aspx>.

[504] PITA 1967, s 2.

[505] Malaysia-Thailand Joint Authority, *What Is JDA* <http://www.mtja.org/whatisjda.php>.

Therefore, as part of the double tax agreement, there are special rates for petroleum income tax in the area. For the first eight years, contractors do not have to pay any petroleum income tax. For the next seven years, they have to pay 10 per cent petroleum income tax to each government, which makes 20 per cent in total. Considering zero per cent and 20 per cent are lower than the benchmark tax rate of 25 per cent, the petroleum income tax rate for the first 15 years of operation is a tax expenditure. However, for any subsequent years of production, 20 per cent of petroleum income tax is payable to both Malaysia and Thailand, which means contractors need to pay a total of 40 per cent tax. This is a negative tax expenditure and is explored in Section 6.7.2.

The agreement also specifies a reduction of 50 per cent from the normal corporate income tax rate for other income received from the joint development area. This clause is to eliminate double taxation, since contractors have to pay income tax to both countries. Hence it is part of a benchmark, and not a tax expenditure.

This policy is intended to attract more companies to undertake petroleum operations in the joint-development area. In the long run, the tax rate applicable in the area is higher than the existing tax rate under PITA 1967, which is 38 per cent. Furthermore, companies operating in this area have to comply with two tax systems – Malaysia's and Thailand's – and this will certainly increase tax compliance cost among companies. Therefore, this tax expenditure is offered to reduce the burden and to make investment in the area more attractive.

Since the reduction in tax rate is designed to counteract the higher future tax rate, and it is not feasible to reduce the tax rate to balance Thailand's high petroleum tax rates (Thailand imposes a 50 per cent tax rate for income from petroleum operations), a tax expenditure in the form of preferential tax rates is a reasonable policy.

4.12 ALTERNATIVE CLASSIFICATION FOR ECONOMIC CORPORATE TAX EXPENDITURES

There are several ways to classify tax expenditures. Sections 4.4 to 4.11 classify tax expenditures based on the objectives they aim to achieve. Since direct spending programs are usually allocated to a particular government ministry or agency, providing alternative classification on a means of government spending could give additional insight as to the total spending, both direct and indirect (that is, tax expenditures), incurred by the ministry or agency; hence offering more information for budgetary analysis. In this section, tax expenditures are classified according to the ministry in charge, as practiced by the government in its yearly Federal Budget Estimates produced by the Ministry of Finance. A reference column is provided to facilitate cross-referencing with its functional category, under which the tax expenditure analysis is provided.

4.12.1 Ministry of International Trade and Industry

The Ministry of International Trade and Industry of Malaysia is responsible for the country's industrial development. It functions to strengthen foreign and domestic investment in the manufacturing sector, and to support exports of Malaysian products.[506] It also controls tax expenditures for SMEs, which are administered by an agency under the ministry, the Small and Medium Enterprise Corporation Malaysia.[507]

[506] Ministry of International Trade and Industry Malaysia, *About MITI* <http://www.miti.gov.my/cms/content.jsp?id=com.tms.cms.section.Section_8ab39698-7f000010-72f772f7-29d380cd>.

[507] Small and Medium Enterprise Corporation Malaysia, *FAQs* <http://www.smecorp.gov.my/v4/node/16>.

	Economic Corporate Income Tax Expenditures	Section
1.	Pioneer status or investment tax allowance for the general manufacturing sector	4.4.1
2.	Pioneer status or investment tax allowance for activities and products that are of national and strategic importance	4.4.3
3.	Pioneer status or investment tax allowance for high technology companies	4.4.4
4.	Pioneer status or investment tax allowance for medical device testing laboratories	4.4.5
5.	Pioneer status or investment tax allowance for the machinery and equipment industry	4.4.6
6.	Pioneer status or investment tax allowance for the automotive component modules industry	4.4.9
7.	Reinvestment allowance for the manufacturing sector	4.4.10
8.	Double deduction for freight charges from Sabah or Sarawak to Peninsular Malaysia	4.4.14
9.	Double deduction for advertising Malaysian brand name goods	4.4.15
10.	Accelerated capital allowance for plant and machinery used for reinvestment in promoted activities and promoted products	4.4.19
11.	Tax exemption or investment tax allowance for IDR-status companies	4.5.2(a)
12.	Tax exemption for IDR developers	4.5.2(b)
13.	Tax exemption for IDR development managers	4.5.2(c)
14.	Tax exemption for non-resident companies on income received from IDR status companies/developers/development managers	4.5.2(d)
15.	Tax exemption or investment tax allowance for tourism, healthcare and education sectors in IM	4.5.2(e)
16.	Double deduction for insurance premiums for the import and export of cargo	4.8.1
17.	Double deduction for export credit insurance premiums	4.8.2

18.	Double deduction for the promotion of exports	4.8.3
19.	Double deduction for the promotion of export of services	4.8.4
20.	Double deduction for participation in international trade fairs	4.8.6
21.	Allowances for increased exports	4.8.7
22.	Tax exemption on income from organising international trade exhibitions in Malaysia	4.8.8
23.	Tax exemption or investment allowance for approved service projects	4.10.1(a)
24.	Group relief	4.11.1(c)
25.	Tax exemption on income received from approved businesses under the special incentive scheme	4.11.1(d)
26.	Initial allowance in the capital allowance scheme for general plant and machinery and industrial buildings	4.11.1(e)
27.	Preferential tax rate for SMEs	4.11.2(a)
28.	Pioneer status or investment tax allowance for small scale manufacturing companies	4.11.2(b)

4.12.2 Ministry of Agriculture and Agro-Based Industries

The Ministry of Agriculture and Agro-Based Industries focuses on the growth of the agriculture sector of the country, including food production, to modernise the sector and make it more competitive.[508]

[508] Ministry of Agriculture and Agro-Based Industry Malaysia, *Profile MOA: Vision and Mission* <http://www.moa.gov.my/web/guest/visi-misi>.

	Economic Corporate Income Tax Expenditures	Section
1.	Pioneer status or investment tax allowance for the general agricultural sector	4.4.1
2.	Pioneer status or investment tax allowance for reinvestment in the food processing industry	4.4.2
3.	Pioneer status or investment tax allowance for reinvestment in cold chain facilities and services	4.4.11
4.	Reinvestment allowance for selected agricultural sectors	4.4.10
5.	Double deduction for expenses to obtain halal certification	4.4.12
6.	Investment tax allowance for halal food production	4.4.13
7.	Allowance for investment in subsidiaries engaged in the production of approved food products	4.4.16(a)
8.	Tax exemption for companies engaged in the production of approved food products	4.4.16(b)
9.	Accelerated capital allowance for machinery and equipment used in the agricultural sector	4.4.18

4.12.3 Ministry of Finance

The tax expenditures for the financial services industry are under the control of the Central Bank of Malaysia and the Securities Commission; both report to the Ministry of Finance.[509] General tax expenditures that are not relevant to other ministries - tax exemptions on foreign income, capital gains and income from government grants or subsidies, are also classified under the Ministry of Finance. In addition, tax expenditures for petroleum companies are also classified here since Petronas, the company that solely owns and manages the nation's petroleum resources, is a company fully owned by the government.

[509] Central Bank of Malaysia, *About the Bank* (12 February 2012) <http://www.bnm.gov.my/index.php?ch=en_about&pg=en_intro&ac=641&lang=en>; Securities Commission Malaysia, *About Us: What We Do* <http://www.sc.com.my/main.asp?pageid=219&menuid=188&newsid=&linked=&type=>.

	Economic Corporate Income Tax Expenditures	Section
1.	Preferential tax rate of 3% or fixed tax of MYR 20,000 (AUD 6,700) for Labuan trading activities	4.7.1(a)
2.	Tax exemption on income from Labuan non-trading activities	4.7.1(b)
3.	Tax exemption on income from qualifying professional services in Labuan	4.7.1(c)
4.	Global Incentive for Trading Programme for the Labuan International Commodity Trading Company	4.7.1(d)
5.	Double deduction for the Promotion of Malaysia as an International Islamic Financial Centre	4.7.2(a)
6.	Tax exemption on income received from Islamic banking and *takaful* businesses	4.7.2(b)
7.	Tax exemption on interest received from Malaysian non-Ringgit Islamic securities	4.7.2(c)
8.	Tax exemption on income from the trading of non-Ringgit *sukuk*	4.7.2(d)
9.	Allowance for the cost of issuance of Islamic securities	4.7.2(e)
10.	Tax exemption on fees received from managing Islamic funds	4.7.2(f)
11.	Tax exemption on interest received by non-resident companies	4.7.3
12.	Tax exemption on profits from overseas' new branches/investee companies	4.7.4
13.	Tax exemption on interest received from government savings certificates	4.7.5
14.	Tax exemption for foreign income	4.11.1(a)
15.	Tax exemption for capital gains	4.11.1(b)
16.	Preferential tax rate for the petroleum operations in the Joint Development Area	4.11.3(a)

4.12.4 Ministry of Domestic Trade, Co-operatives and Consumerism

One of this ministry's missions is to have an effective intellectual property rights regime to promote creativity and innovation for the development of domestic trade.[510] Franchise businesses are also regulated by this ministry.[511]

	Economic Corporate Income Tax Expenditures	Section
1.	Accelerated capital allowance for the cost of acquisition of proprietary rights of manufacturing companies	4.4.17
2.	Accelerated capital allowance for franchise fees	4.8.9
3.	Accelerated capital allowance for the registration of patents and trademarks (for SMEs)	4.11.2(c)

4.12.5 Ministry of Plantation Industries and Commodities

This ministry is responsible for the commodity sector and commodity-based industries.[512] Among commodities promoted by the ministry are palm oil, rubber, timber, cocoa, kenaf, tobacco, and pepper.

	Economic Corporate Income Tax Expenditures	Section
1.	Pioneer status or investment tax allowance for reinvestment in resource-based industries	4.4.2
2.	Pioneer status or investment tax allowance for utilisation of palm oil biomass to produce value-added products	4.4.7
3.	Pioneer status or investment tax allowance for reinvestment in utilisation of palm oil biomass to produce value-added products	4.4.8
4.	Double deduction for freight charges on exports of rattan and	4.8.5

[510] Ministry of Domestic Trade, Co-operatives and Consumerism Malaysia, *Vision and Mission* <http://www.kpdnkk.gov.my/en/kpdnkk/profil/misi-visi>.

[511] Ministry of Domestic Trade, Co-operatives and Consumerism Malaysia, *Franchise Development Division* <http://www.kpdnkk.gov.my/en/kpdnkk/org/pembangunan-francais/fungsi>.

[512] Ministry of Plantation Industries and Commodities Malaysia, *Our Vision, Mission and Objectives* <http://www.kppk.gov.my/en/about-us/profiles/vision-mission-a-objectives-mainmenu-47.html>.

	wood-based products	
5.	Pioneer status for commercialisation of resource-based R&D findings	4.9.5(a)
6.	Allowance for investment in a project of commercialisation of resource-based R&D findings	4.9.5(b)
7.	Tax exemption on income of foreign companies attained from trading in Malaysia through consignees in specific commodities	4.10.3

4.12.6 Ministry of Science, Technology and Innovation

The scope of the Ministry of Science, Technology and Innovation includes promoting creativity and innovation, strengthening R&D and finding new technology.[513]

	Economic Corporate Income Tax Expenditures	Section
1.	Double deduction for expenses incurred to obtain quality systems and standards certification	4.4.12
2.	Pioneer status or investment tax allowance for MSC status companies	4.5.3(a)
3.	Tax exemption for non-resident companies on income received from MSC status companies	4.5.3(b)
4.	Double deduction for research expenditure	4.9.1
5.	Pioneer status or investment tax allowance for contract R&D companies	4.9.2(a)
6.	Pioneer status or investment tax allowance for reinvestment in contract R&D companies	4.9.2(b)
7.	Investment tax allowance for R&D companies	4.9.3(a)
8.	Investment tax allowance for reinvestment in R&D companies	4.9.3(b)
9.	Investment tax allowance for in-house R&D companies	4.9.4(a)
10.	Investment tax allowance for reinvestment in in-house R&D companies	4.9.4(b)

[513] Ministry of Science, Technology and Innovation Malaysia, *Introduction* <http://www.mosti.gov.my/index.php?option=com_content&view=article&id=1764&Itemid=57&lang=en>.

4.12.7 Ministry of Tourism

The Ministry of Tourism aims to develop the tourism industry so that it generates more revenue for the country.[514]

	Economic Corporate Income Tax Expenditures	Section
1.	Double deduction for the promotion of Malaysian tourism overseas	4.6.1
2.	Tax exemption on income from the provision of chartering services of luxury yachts	4.6.4
3.	Tax exemption on income attained from organising conferences in Malaysia	4.6.5
4.	Pioneer status or investment tax allowance for the hotel business and tourism industry	4.6.6(a)
5.	Pioneer status or investment tax allowance for reinvestment in the hotel business and tourism industry	4.6.6(b)

4.12.8 Ministry of Transport

The Ministry of Transport is responsible for all types of transportation within the country, including rail, maritime and aviation transportation, and ports.[515]

	Economic Corporate Income Tax Expenditures	Section
1.	Tax exemption for a "Malaysian Ship"	4.10.2(a)
2.	Tax exemption on income attained from the rental of ISO containers by non-residents	4.10.2(b)
3.	Tax exemption on income attained from the rental of ships by non-residents	4.10.2(c)

[514] Ministry of Tourism Malaysia, *Policy of the Ministry* <http://www.motour.gov.my/en/ministrys-profile/policy-of-the-ministry.html>.

[515] Ministry of Transport Malaysia, *Ministry of Transport* <http://www.mot.gov.my/en/About/Pages/MinistryofTransport.aspx>.

4.12.9 Ministry of Health

The healthcare tourism sector in Malaysia is administered by the Malaysia Healthcare Travel Council, which is established under the Ministry of Health.[516] The council promotes Malaysia as a medical tourism destination, which attracts patients from foreign countries to get quality yet affordable health services in private hospitals in Malaysia.

	Economic Corporate Income Tax Expenditures	Section
1.	Allowance for healthcare service providers for services to foreign clients	4.6.7(a)
2.	Allowance for private hospitals involved in healthcare travels	4.6.7(b)

4.12.10 Ministry of Information, Communications and Culture

One of the objectives of the Ministry of Information, Communications and Culture is to develop and monitor communication facilities and services.[517]

	Economic Corporate Income Tax Expenditures	Section
1.	Tax exemption for non-resident film companies	4.6.2
2.	Accelerated capital allowance for ICT equipment	4.10.1(b)

[516] Malaysia Healthcare Travel Council, *About Us* <http://www.mhtc.org.my/en/mission-vision-background.aspx>.

[517] Ministry of Information, Communications and Culture Malaysia, *Function and Objective* (5 November 2009) <http://www.kpkk.gov.my/index.php?option=com_content&view=article&id=269&Itemid=109& lang=en>.

4.12.11 Ministry of Rural and Regional Development

The Ministry of Rural and Regional Development focuses on the wellbeing of people who live in rural areas and the development of rural and less-developed areas.[518]

	Economic Corporate Income Tax Expenditures	Section
1.	Pioneer status or investment tax allowance in promoted areas	4.5.1(a)
2.	Pioneer status or investment tax allowance for the relocation of manufacturing activities to promoted areas	4.5.1(b)
3.	Pioneer status or investment tax allowance for new investments in 4-star and 5-star hotels in Sabah and Sarawak	4.5.1(c)
4.	Infrastructure allowance	4.5.1(d)
5.	Tax exemption or investment allowance for approved service projects in promoted areas	4.5.1(e)
6.	Tax exemption or investment tax allowance for agricultural projects, seeds R&D centres and premier industrial parks within NCER	4.5.4

4.12.12 Ministry of Works

Apart from monitoring the country's infrastructural development, the Ministry of Works also aims to develop the nation's construction industry.[519]

	Economic Corporate Income Tax Expenditures	Section
1.	Accelerated capital allowance for mould used in the production of Industrialised Building System components	4.10.4

[518] Ministry of Rural and Regional Development Malaysia, *Objective* <http://www.rurallink.gov.my/objective>.

[519] Ministry of Works Malaysia, *Profile* (15 February 2013) <http://www.kkr.gov.my/en/organization/profile>.

4.12.13 Ministry of Youth and Sports

Sport activities, including motorsports, are under the responsibility of the Ministry of Youth and Sports.[520]

Economic Corporate Income Tax Expenditures	Section
1. Tax exemption for organisers of car and motorcycle races	4.6.3

4.12.14 Ministry of Energy, Green Technology and Water

The Ministry of Energy, Green Technology and Water is responsible to all matters related to electricity, including its supply and consumption.[521]

Economic Corporate Income Tax Expenditures	Section
1. Accelerated capital allowance for power quality equipment	4.10.1(c)

4.13 ECONOMIC INCENTIVES NOT REGARDED AS TAX EXPENDITURES

There are several tax treatments that have been regarded as tax incentives by the government but are not regarded as tax expenditures in this thesis because they form part of a benchmark. In general, these are transactions that are not regarded as income earning activities for tax purposes or are held as capital expenditures, but in accounting are treated as business expenses and are deducted in the calculation of profits.

From a tax perspective, expenses have to be "wholly and exclusively incurred in the production of gross income"[522] to be deductible for tax purposes. Consequently,

[520] Ministry of Youth and Sports Malaysia, *Vision, Mission, Objectives* <http://www.kbs.gov.my/index.php/en/info-korporat/visi-misi-objektif>.
[521] Ministry of Energy, Green Technology and Water Malaysia, *Objectives of Energy Sector* (9 November 2010) <http://www.kettha.gov.my/en/content/objectives-energy-sector>.
[522] ITA 1967, s 33(1).

although an expense is related to a business, deduction cannot be allowed, and amount incurred is a total loss, if the expense is not made to produce income. On the other hand, accounting standards require all financial transactions in operating a business to be accounted for. It recognises that as a business entity, there are more responsibilities that companies need to fulfil other than its primary activity of making profit, such as responsibilities to its investors, to the environment and to the public. As a result, the scope of business expenses in accounting is much wider than in taxation.

The following allowable tax deductions are announced as incentives by the government because they would not be deductible for tax purposes under traditional legal doctrines that would not identify a nexus between the outgoings and the current derivation of income. They are not tax expenditures, though they fall under the broader accounting banner of business expenses.

4.13.1 Tax Deduction for Pre-Operational and Pre-Commencement Expenses

The IC Interpretation 201 *Preliminary and Pre-Operating Expenditure* issued by the MASB requires these expenses to be written off as incurred as they do not fulfil the basic requirement for assets.[523] For tax purposes, they are non-deductible because they are incurred to put the company into an operating condition, not to produce income. The "income producing" stage has not started. Thus they are regarded as capital in nature and are not allowed to be deducted in the calculation of taxable income. Hence, non-deductible pre-operational and pre-commencement expenses are negative tax expenditures, and are discussed in Section 6.3.4.

The government has allowed a deduction for a few types of pre-operating and pre-commencement expenditures. They are provided under ITA 1967 and under income tax rules, and have been further explained by IRBM Public Ruling No 2/2010 *Allowable Pre-Operational and Pre-commencement of Business Expenses*. These expenses are presented below:

[523] MASB, IC *Interpretation 201 Preliminary and Pre-Operating Expenditure* paras 3, 7. IC Interpretation provides guidance on accounting treatment not covered by FRSs. This IC Interpretation is a locally developed interpretation and may not be available in other countries.

a. Tax Deduction for Expenses Related to Investment in Overseas Business Ventures

The ITA 1967 schedule 4B allows a few pre-operational expenses related to investment in overseas business ventures as deductible expenses. This incentive was given to encourage Malaysian investors to explore overseas business opportunities.[524] Expenses allowed are those incurred:

- To conduct feasibility studies;
- To conduct market research or to obtain marketing information; or
- For overseas travelling expenses for one person necessary to conduct feasibility studies or market surveys, and actual accommodation and sustenance expenses (limited to MYR 400, equivalent to AUD 130, per day).

b. Tax Deduction Establishment Expenses of Islamic Stock Broking Companies

Expenses incurred during the establishment of an Islamic stock broking company, which include consultancy and legal fees, cost of feasibility studies, cost of market research, and cost of obtaining licenses and business approval, can be deducted for tax purposes. However, this deduction is available for applications made between 2 September 2006 and 31 December 2015 only.[525]

c. Tax Deduction for Incorporation Expenses of SMEs

Companies with authorised capital of not more than MYR 2,500,000 (AUD 833,000) can deduct their incorporation expenses in the first year of commencing business. Eligible incorporation expenses are:[526]

- The cost of preparing and printing the memorandum of association, the articles of association and the prospectus, and of circulating and advertising the prospectus;

[524] *Malaysian Budget Speech 1991* in Malaysia, *Parliamentary Debates*, House of Representatives, 14 December 1990, 1155-1156 (Daim Zainuddin).

[525] Income Tax (Deduction on Expenditure for Establishment of an Islamic Stock Broking Business) Rules 2007; Income Tax (Deduction on Expenditure for Establishment of an Islamic Stock Broking Business) (Amendment) Rules 2009.

[526] Income Tax (Deduction for Incorporation Expenses) Rules 2003; Income Tax (Deduction for Incorporation Expenses) (Amendment) Rules 2005.

- The cost of company registration and the statutory documents (including any fees and stamp duties);
- The cost of drawing up the preliminary contracts (including any stamp duties);
- The cost of printing debentures (including any stamp duties) of share certificates and letters of allotment;
- The cost of the company's seal; and
- Underwriting commission.

These incentives allow pre-commencement and pre-operational expenses to be deducted for the calculation of tax in the first year of operation. This tax treatment is similar to the requirement of accounting standards. Hence, they cannot be treated as a tax expenditure. When some of the incentives expire, they should be classified as negative tax expenditures.

4.13.2 Tax Deduction for Donations and Cash Contributions

Donations and cash contributions by companies are part of corporate social responsibility and could affect a company's profitability. As the law generally recognises companies as an artificial person, it has a person's rights and responsibilities, including giving donations. In accounting, a donation is a business expense, and should be deducted in the income statement. Although tax deductions for certain donations act as incentives,[527] they are actually part of the benchmark tax base. Disallowing full deduction could make the donations a negative tax expenditure (nevertheless, this thesis argues that restricting deduction for donation is also part of the benchmark tax base). Discussion regarding this matter is available in Section 6.8.1.

[527] ITA 1967, ss 34(6)(g), 34(6)(h), 34(6)(ha), 44(6), 44(6A), 44(7), 44(8), 44(9), 44(10), 44(11), 44(11A), 44(11B), 44(11C).

4.13.3 Tax Deduction for Audit Expenditure

By principle, audit expenditure is not deductible for tax purposes because it does not contribute directly to the production of income. However, as an incentive to improve compliance among corporate sectors,[528] the government allows a deduction.[529] On the other hand, audit expenditure is a business expense in accounting. Since the tax incentive follows the accounting treatment for audit expenditure, it is not a tax expenditure.

4.13.4 Tax Exemption on Income from Government Grants or Subsidies

The accounting treatment of government grants is based on MFRS 120 *Accounting for Government Grants and Disclosure of Government Assistance*. The standard divides government grants into two types: grants related to assets; and grants related to income. Grant related to assets are grants that require acquisition or construction of assets. There are two alternative methods for the accounting treatment of grants related to assets. The first method is to recognise the grant as income systematically over the useful life of the asset, and the second method shows the grant as a reduction in the amount of depreciation expense.[530] A grant related to income is shown as income in the period that matches with the costs or expenses it intended to compensate.[531] All methods treat government grants as a revenue in the income statement; hence government grants constitute part of the accounting profit.

Although tax law provides tax exemptions on income from government grants, any expenses paid using the grant money have to be disregarded in the calculation of taxable income.[532] Or, if the grant money is used to purchase a depreciable asset, the asset is not eligible for capital allowance. The tax treatment is therefore producing the

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[528] *Malaysian Budget Speech 2006,* para 34; Appendix 6.
[529] Income Tax (Deduction for Audit Expenditure) Rules 2006.
[530] IFRS Foundation, *MFRS 120 Accounting for Government Grants and Disclosure of Government Assistance*, paras 24-27.
[531] IFRS Foundation, *MFRS 120 Accounting for Government Grants and Disclosure of Government Assistance*, para 12.
[532] Income Tax (Exemption) (No. 22) Order 2006; IRBM Guidelines on Tax Exemption of Grants or Subsidies, and Income of Statutory Authority.

same result as the accounting treatment. In accounting, the grant is recognised as income, but the expense or depreciation incurred must be deducted in the income statement. Hence, no tax expenditure arises.

However, the tax treatment can be a tax expenditure if a company is awarded an untied grant. An untied grant is a grant that the recipient is not required to apply to particular acquisitions or expenditures. This may happen, for example, where the national or a local government provides a grant to a foreign company to relocate a plant in Malaysia or a particular region in Malaysia. In this case, accounting standards would require the taxpayer to recognise the grant as income in the period of receipt and separately recognise the cost of acquisitions paid from the grant receipt through the ordinary deduction or depreciation system. The tax law, in contrast, would allow taxpayers to defer the initial recognition until the funds were used or the assets acquired with the funds depreciated. The timing difference (the effective deferral of recognition under the tax law) would give rise to a tax expenditure. However, this type of grant is a rare phenomenon in Malaysia as grants are normally tied to specific expenses or assets.

4.14 SUMMARY

This chapter identifies economic corporate income tax expenditures in Malaysia using the benchmark established in Section 3.6 and analyses them using the conventional tax expenditure analysis. Economic tax expenditures are introduced to support the country's economic development, generally to strengthen the local market so it can attract foreign investors and consumers. This should have a positive impact on the country's balance of payments account.

The tax expenditures come in various types: tax exemptions, allowances, double deductions, preferential tax rates and accelerated capital allowances. All of these tax expenditures are clear deviations from accounting practices. Even if S-H-S income is used as the benchmark tax base, they will still be classified as tax expenditures. No tax base allows a certain set-off to the income (that is, the allowances), nor double deduction.

Malaysia has a large number of tax expenditures. Tax expenditure reporting is therefore very important. In the absence of a report that provides information about how much revenue has been forgone in allowing tax expenditures, the government may continue to give tax incentives without knowing how much they actually cost them. Having a tax expenditure report would encourage more research to be done regarding the effectiveness of a tax expenditure, and whether a tax expenditure is the best method to achieve the government's objective in providing the tax incentive.

A large number of tax expenditures represent unnecessary government intervention in problems that should be left corrected by the market. Many tax expenditures are redundant, and act to encourage companies to undertake activities that they would still undertake even if no tax incentive were available. Even in cases where government assistance is required, the flawed design of the expenditures has meant that the needy group have been missed, or profitable companies have benefited more. Huge government resources, amounting to billions of dollars, have been wasted.

If there is a case for government assistance, the best method to help companies is through grants or loans. Usually prior to approval of grants or loans, applicants are assessed on a case-by-case basis to ensure eligibility, and the amount of assistance given is tailored to the business needs, rather than the blanket, one-size-fits-all approach of tax expenditures. This makes direct government expenditure superior to tax expenditures.

CHAPTER FIVE

A TAX EXPENDITURE ANALYSIS OF MALAYSIA'S SOCIAL CORPORATE INCOME TAX EXPENDITURES

5.1 INTRODUCTION

This chapter focuses on social corporate tax expenditures, that is, tax expenditures which are introduced to encourage participation by companies in upholding social responsibilities together with the government. The social tax expenditures are divided into three categories based on their functions or objectives: human capital development, environmental protection, and welfare and safety.

1. *Human capital development*. Tax expenditures in this category aim to promote private sector involvement in continuous training and education in order to produce a highly skilled and educated nation.

2. *Environmental protection.* Tax expenditures in this category are introduced to encourage private sector organisations to protect and care for the environment while doing business.

3. *Welfare and safety.* This category is subdivided into two functions – welfare and safety. The first is to encourage companies to care for the wellbeing of those in need and the latter is to encourage companies to work together with the government to create a safer community.

The presentation format of this chapter follows the presentation of Chapter Four. For each tax expenditure, information about the tax expenditure type, a brief description of the tax expenditure and the reason for its enactment, and its effective and expiry year

and source is provided. Only tax expenditures that are enacted and have not expired as at 30 June 2012 are included in this chapter.

The analysis of tax expenditures follows thereafter, using the same tax expenditure analysis framework as described in Section 4.2. The tax expenditure analysis involves three distinct steps:

(i) identification of tax expenditures and negative tax expenditures based on the benchmark tax structure;
(ii) consideration of the reasons for government intervention, whether there are market failures, positive externalities or negative externalities that cause the government to believe that a subsidy or penalty is needed to affect corporate behaviour; and
(iii) analysis of whether alternative policies such as direct expenditure or regulation might achieve the intended outcome more efficiently.

The first step generally depends on the type of tax expenditures and they have been explained in Section 4.3, where all double deductions, allowances and tax exemptions are tax expenditures because they clearly deviate from accounting practices. Whether an accelerated capital allowance is a tax expenditure depends on the accounting useful life of the asset.

In addition, this chapter provides an alternative classification for the social corporate income tax expenditures based on the responsibilities of government ministries. The chapter also lists tax incentives that are not regarded as tax expenditures because they are in fact part of the benchmark tax structure.

5.2 HUMAN CAPITAL DEVELOPMENT

The term 'human capital' refers to the sum of the abilities and knowledge of individuals.[533] A large labour supply without proper education and training does not produce 'capital'. Human capital is vital to support a country's growth, and the creation of human capital is a long-term process. Therefore, government works closely with the corporate sector to provide education and training to citizens. The process must start from the early years in school and continue even after a person has already entered the job market. Various tax expenditures are available to support the development of human capital in Malaysia.

5.2.1 Corporate Training and Recruitment

Skills and work experience are essential factors considered by an employer during a recruitment search. It is important for government to obtain cooperation from the private sector to provide training not only for employees but also for non-employees. This could involve additional cost to companies, and thus the government offers tax expenditures to encourage private sector involvement. There are five tax expenditures for corporate training and recruitment, all of which are offered in the form of a double deduction. Analyses for (a) and (b) are combined due to their close similarities.

[533] Stefan Bergheim, 'Human Capital is the Key to Growth: Success Stories and Policies for 2020' (Current Issues: Global Growth Centres, Deutsche Bank Research, 1 August 2005) 3-4.

a. Double Deduction for Expenses on Approved Training for Employees

Type	Double deduction
Brief Description	Cost of employee training can be deducted twice. Training must be of approved programs conducted by approved institutions.
Reason(s)	To encourage companies to train their employees to make sure the country has enough skilled manpower.[534]
Effective Year	1991, with amendments later
Expiry Year	-
Source(s)	• Income Tax (Deductions for Approved Training) Rules 1992. • Income Tax (Deductions for Approved Training) (Amendment) Rules 1995.
Additional Information	-

b. Double Deduction for Expenses on Technical Training for Employees

Type	Double deduction
Brief Description	Fees incurred on technical training of employees can be deducted twice.
Reason(s)	To ensure Malaysia has an adequate pool of skilled labour and to strengthen competitiveness among Malaysian professional industries.[535]
Effective Year	2009
Expiry Year	2012
Source(s)	• Income Tax (Deduction for Cost of Training for Employees) Rules 2009
Additional Information	Training is limited to courses conducted by International Centre of Education in Islamic Finance (INCEIF) in Islamic Finance,[536] and postgraduate courses in information technology and communication, electronics or life sciences, post basic course in nursing and allied healthcare, and aircraft maintenance engineering approved by the Minister.

[534] *Malaysian Budget Speech 1991* in Malaysia, *Parliamentary Debates*, House of Representatives, 14 December 1990, Appendix 10 (Daim Zainuddin).

[535] *Malaysian Budget Speech 2009,* Appendix 11.

[536] INCEIF is a 'global university' specialising in the area of Islamic Finance. It offers three courses – Chartered Islamic Finance Professional, Masters in Islamic Finance and PhD in Islamic Finance.

The double deductions for approved training [as explained in Section 5.2.1(a)] and technical training for employees are available only for companies that cannot make a claim from the Human Resources Development Fund (HRDF). The HRDF, a pool of funds established in 1993 and managed by an agency under the Ministry of Human Resources, provides grants for companies to upgrade their employees' skills through training.[537] Companies that fulfil certain criteria are required to make mandatory levy payments to the fund, currently set at the rate of one per cent of monthly wages. The financial assistance received is a cost-sharing effort between companies and government, where companies pay the levy, and government adds grants to the fund. Companies subject to mandatory contributions to the HRDF are:[538]

1. Manufacturing companies with at least 50 employees.
2. Manufacturing companies with 10 to 49 employees and paid up capital of at least MYR 2.5 million (AUD 833,000).
3. Service companies (that is, those providing services in the following industries: hotel accommodation, air transport, tour operating services, telecommunications, freight forwarding, shipping, postal and courier services, advertising, computer services, energy, training, private higher education, direct selling, port services, engineering support and maintenance services, R&D, warehousing services, security services, private hospital services, commercial land transport and railway transport services) with at least 10 employees, and service companies comprising hypermarkets, supermarkets and departmental stores with at least 50 employees.

Manufacturing companies with 10 to 49 employees but with paid up capital of less than MYR 2.5 million (AUD 833,000) can also choose to register for the HRDF. Companies that have paid the mandatory levy can apply for various training grants from the HRDF to cover the cost of retraining and upgrading of skills of their employees. With the availability of HRDF grants, the double

[537] Pembangunan Sumber Manusia Berhad, *About HRDF* <http://www.hrdf.com.my/wps/portal/PSMB/MainEN/corporate-profile/about-psmb>.
[538] *Pembangunan Sumber Manusia Berhad Act 2001* First Schedule.

deductions for employee training are limited to companies that are not registered with the HRDF, such as companies from the banking and financial services industry.

Government intervention through the double deduction and HRDF shows that the government view is that companies do not provide sufficient training for their employees. A review of the 1991 Budget announcement when the double deduction was introduced reveals that there was a short supply of skilled labour at that time and that the government decided to overcome this problem by offering a double deduction relief.[539] However, on a rational analysis, when companies are not able to hire skilled workers, they can send their unskilled and semi-skilled workers for training. The lack of skilled workers can affect the performance of the companies, and they are willing to incur cost to rectify the problem. If these companies are worried that the workers they have trained will move to other companies, they can enter into a bond with the workers, whereby after completing the training, the workers must serve the company for a stipulated period.

Since the problem of skilled workers can be solved by the companies themselves, why would the government wish to intervene? An increase in the number of skilled workers provides an advantage to the nation; hence the government feels obliged to cover part of the training cost. Alternatively, the government may seek to assist training institutions by increasing their business opportunities, as companies will send workers for training to a greater extent than they would normally do so. This could also be a short-term solution that has been erroneously implemented as a long-term measure.

Assuming that there is a need for the government to interfere in the market and provide government assistance of some kind to encourage employee training, it would be better for the government to open the HRDF to all sectors than to offer a tax expenditure the total cost of which is difficult to measure and monitor. If the government considers that the current HRDF fund is too generous for certain

[539] *Malaysian Budget Speech 1991* in Malaysia, *Parliamentary Debates*, House of Representatives, 14 December 1990, 1132-1133 (Daim Zainuddin).

sectors, a separate fund could be established. Nevertheless, it is crucial for the government to first assess the need to provide financial assistance.

c. Double Deduction for Expenses on Approved Training for Handicapped Persons

Type	Double deduction
Brief Description	Cost of training of handicapped persons who are not employees can be deducted twice.
Reason(s)	To improve the employability of handicapped people.[540]
Effective Year	1991
Expiry Year	-
Source(s)	• Income Tax (Deductions for Approved Training) Rules 1992
Additional Information	- The handicapped person must be registered with the Ministry of National Unity and Social Development. - Training must be of approved programs conducted by approved institutions.

Companies are also encouraged to provide training to non-employees. Handicapped persons could under normal circumstances face stiff competition from non-handicapped persons during job search, but with proper training and subsequent employment, they could be independent and make their own living rather than needing to rely on government assistance to live. Since the training is provided to handicapped persons who are not employees, the training has no benefit to companies; hence the government considers it necessary to intervene.

Since the training is to be undertaken in approved institutions, not within the company, the same objective can be achieved if the government provides direct assistance to the handicapped persons, and not through the company. Subsidies could also be given through the training institutions so as to provide, for example, that enrolled handicapped persons need only pay 10 per cent of the training fees, whereas the 90 per cent balance is paid by the government directly to the training

[540] *Malaysian Budget Speech 1991* in Malaysia, *Parliamentary Debates*, House of Representatives, 14 December 1990, Appendix 10 (Daim Zainuddin); Veerinderjeet Singh, *Veerinder on Taxation,* (Arah Publications, 2008) vol 2, 782.

institutions. Company involvement seems irrelevant unless after the end of training, the company employs the handicapped person.

d. Double Deduction for Implementation of Structured Internship Program

Type	Double deduction
Brief Description	Expenses incurred on structured internship program that provides practical training to university students can be deducted twice.
Reason(s)	To encourage companies to participate in this program that can develop high-skilled human capital.[541]
Effective Year	2012
Expiry Year	2016
Source(s)	• Income Tax (Deduction for Expenditure Incurred for the Provision of an Approved Internship Programme) Rules 2012
Additional Information	- Among qualifying criteria are: o Participants are full time students from Private/Public Higher Educational Institutions; o Minimum period for the internship program is 10 weeks; o Students are paid a monthly allowance of at least MYR 500 (AUD 170). - Eligible expenses are: o Internship allowance paid to students; o Expenses incurred on training the students; o Expenses incurred on meal, travelling and accommodation for the students during the internship program; o Fee paid to a person who has been appointed to conduct an approved internship program. - The eligible expenses for the double deduction, with exception to the internship allowance, are limited to MYR 5,000 (AUD 1,700) per annum.

An internship program is important for students in higher educational institutions to enable them to practice what they have learnt in the classroom. It is normal for universities in Malaysia to include one semester of internship as part of the four year bachelor degree program. However, students must look for the job placement themselves with the help from their universities, and if they cannot find a place, they cannot complete their degree. Companies on the other hand could be reluctant to accept internship students if they already have enough employees because they will incur the additional cost of the internship allowance. Some

[541] *Malaysian Budget Speech 2012* para 46; Appendix 12.

companies accept internship students but pay a very minimal or nil allowance, making it very hard for the students to survive during the internship period.

Thus, the government adds a motivating factor for companies to accept a greater number of intern students than they need by offering the tax expenditure. This is a justifiable reason for the government intervention. The double deduction should benefit the students since companies now must pay some allowances to the students, apart from the fact that the students can have access to real workplace training.[542] At the same time companies are not burdened by the payment. If converted into direct spending, the government could give financial assistance directly to the students, perhaps paid through their universities. Companies will benefit through a free workforce, and this is a good motivation for them to accept intern students.

[542] The double deduction relief is subjected to stringent conditions, which include the internship program must run for at least 10 weeks, the students must be paid a minimum of MYR500 (AUD 170) monthly allowance, and expenses eligible for the double deduction shall not exceed MYR5,000 (AUD 1,700). Detailed information is provided in the additional information segment in the tax expenditure table.

e. Double Deduction for Participation in Overseas Career Fairs

Type	Double deduction
Brief Description	Expenses incurred by companies in participating in career fairs abroad that are endorsed by Talent Corporation Malaysia Berhad can be deducted twice.
Reason(s)	To attract talented Malaysians and students to return home and work in Malaysia.[543]
Effective Year	2012
Expiry Year	2016
Source(s)	• Income Tax (Deduction for Participation in an Approved Career Fair) Rules 2012
Additional Information	- Eligible expenses are: o Overseas travelling expenses for up to three persons, that is, air fare (economy class), accommodation expenses (limited to MYR 300, equivalent to AUD 100, per day) and sustenance expenses (limited to MYR 150, equivalent to AUD 50, per day); o Marketing and promotional materials; o Payment to the fair organiser; and o Other direct expenses.

The government attempts to attract Malaysian experts who are currently working with foreign corporations overseas to return to Malaysia and work with Malaysian companies. However, private sector involvement is required to ensure jobs are offered to these experts. Hence, the tax expenditure in terms of double deduction is given to encourage companies to participate in overseas career fairs and offer job opportunities. At the same time, the government also launched several programs that give incentives to Malaysian experts working overseas and to Malaysian students who have completed their studies in foreign universities to return to Malaysia and work in local private companies.

By offering this tax expenditure, the government assumes that without their assistance, private companies may not be willing to spend extra money to participate in overseas career fairs. This assumption could be argued to be inaccurate since it is a normal practice for multinational corporations in Malaysia to hire foreigners and serve in their top management. Having local experts with

[543] *Malaysian Budget Speech 2012* para 46; Appendix 14.

international experience should bring an additional advantage to the companies. If they are willing to hire foreigners without any government assistance, they should be more than willing to employ local experts even without any government incentive. What needs to be done by the government is to provide a database of potential employment candidates to identify suitable candidates.

It is claimed that the program to attract Malaysian experts to return home is a success, owing to the effort of companies to reach out to the experts.[544] If the claim is correct, then this tax expenditure has achieved its objectives. This shows that private sector participation is essential, but whether the private sector needs to be assisted requires a different study.

Nevertheless, if government assistance is required to ensure companies' participation, this tax expenditure could simply be replaced by a direct spending program. As a form of direct spending, this tax expenditure is equivalent to payment by the government of part of the travelling, promotional and other expenses incurred to participate in the career fair. Assistance in the form of direct spending is preferable because the costs incurred can be monitored and controlled.

5.2.2 Education

Formal education is an important process in the creation of high quality human capital. The government had allocated MYR 50.2 billion (AUD 16.7 billion) of direct spending to be spent in the education sector in 2012.[545] While most institutions within the education sector are government-owned and funded, there are a few private institutions that the government considers need to be assisted.

[544] Suzanna Pillay, 'Experts Return Home', *New Straits Times* (online), 23 September 2012 <http://www.nst.com.my/top-news/experts-return-home-1.147193>.
[545] *Malaysian Budget Speech 2012*, para 41.

a. Double Deduction for Overseas Promotional Expenses Incurred by Profit-Oriented Private and International Schools

Type	Double deduction
Brief Description	Overseas promotional expenses incurred by profit-oriented private and international schools can be deducted twice.
Reason(s)	To encourage participation of private sector in providing quality education.[546]
Effective Year	2012
Expiry Year	-
Source(s)	Income Tax (Deduction for Promotion of International or Private School) Rules 2012
Additional Information	- Eligible promotional expenses are: o Market research; o Preparation of technical information; o Overseas travelling expenses to participate in education fairs, that is, air fare (economy class), accommodation expenses (limited to MYR 300, equivalent to AUD 100, per day) and sustenance expenses (limited to MYR 150, equivalent to AUD 50, per day); o Participation in approved education fairs; and o Publicity and advertisement in any media outside Malaysia. - The additional deduction allowed is limited to MYR100,000 per year (AUD 33,000). - Schools must be registered with the Ministry of Education. - Application for this incentive should be submitted to MIDA.

The tax expenditure for education is given to profit-oriented private and international schools operating in Malaysia. Although Malaysians generally send their children to public schools, demand for private and international schools comes from high-income groups and from foreign expatriates. Private and international schools are perceived by them to provide better and higher quality education. The tax expenditure aims to encourage these schools to widen their market overseas to attract more foreign students. The presence of foreign students could enhance competitiveness in the schools, improve communications among peers and help the students to understand matters from a different perspective, which in turn improves the quality of the education provided.

[546] *Malaysian Budget Speech 2012*, para 44; Appendix 17.

Further consideration is needed to decide whether these schools should receive government assistance, particularly for the purpose of attracting foreign students. These are profit-oriented schools that impose high fees on students. The students, especially foreign students, come from wealthy families who may not be as sensitive to price as to the need to secure their children high quality education. The overseas promotional expenses could simply be recovered through imposing higher fees on foreign students. Offering this tax incentive means that the school can offer lower fees to the foreign students since part of their cost is funded by the government. The question now is whether they are the needy groups that need to be assisted. It is highly possible that the answer is no.

Nevertheless, these foreign students could have a positive impact on the country's economy as they bring an inflow of cash into the country. This could be the real reason why the government wants to attract more foreign students in schools. The government however, should further analyse whether the benefits these students bring along into the country outweigh the cost incurred by the government through this incentive.

If for some reason the foreign students or the private schools do need government assistance, then it would be better for the assistance to be delivered as a direct expenditure, where the schools can claim for expenses that have been incurred directly from the government.

b. Tax Exemption on Royalty Received by Non-Resident Franchisor of Private Institutions of Higher Learning

Type	Tax exemption
Brief Description	Royalty income received by a non-resident franchisor from a registered private higher educational institution is exempted from tax.
Reason(s)	To promote Malaysia as a centre for excellence in education.[547]
Effective Year	2001
Expiry Year	-
Source(s)	• Income Tax (Exemption) (No. 16) Order 2002
Additional Information	'Franchisor' means the person who grants a franchise in relation to conducting a course of study or training program jointly or in affiliation, association or collaboration with any University, University College, higher educational institution, whether public or private, or professional body, outside Malaysia as specified under section 38 of the *Private Higher Educational Institutions Act 1996*.

The government acknowledges the importance of quality education for young Malaysians. Since the local public universities cannot cater for all these students, and because overseas education is perceived to be of better quality, scholarships are offered to students who have excelled to undertake their tertiary education in foreign universities. Until the 1990s, the government sent about 20 per cent of Malaysians to study abroad.[548] This caused massive cash outflows from the country especially during the 1997 Asian financial crisis. To overcome this problem, the government decided to bring foreign higher educational institutions into Malaysia so that Malaysians could get overseas qualifications locally. In line with this, the government also aims to turn Malaysia into an education hub and attract not only foreign higher educational institutions to operate in Malaysia, but also to attract foreign students to enrol in these institutions. Therefore, the government is offering tax exemption on the royalty income to attract more

[547] *Malaysian Budget Speech 2002*, para 59.

[548] Patrick Blessinger and Enakshi Sengupta, 'Is Malaysia the Regional Leader in International Higher Education?' *Guardian Professional* (online), 2 July 2012 <http://www.guardian.co.uk/higher-education-network/blog/2012/jul/02/higher-education-in-malaysia>.

foreign universities to offer franchised courses in Malaysia. Based on this, it is hypothesised that without the tax exemption, Malaysia is not an attractive destination for these foreign universities to offer franchised education.

The transformation of the Malaysian higher education system took place after the enactment of the *Private Higher Educational Institutions Act 1996*. The new legislation permits foreign universities to open local branches and operate as private higher educational institutions, or to enter into collaboration with the local private institutions.[549] The latter includes franchise courses, and is more popular since the local private institutions adopt the curriculum of the foreign universities but utilise their own facilities and lecturers.

Research shows that the business of private higher educational institutions offering franchise overseas courses has flourished after the new legislation (that is, the *Private Higher Educational Institutions Act 1996)* came into force.[550] The tax exemption on the royalty was introduced around five years later in 2001. There is no evidence that the tax on royalty income has hindered foreign universities in entering into collaboration with local private institutions. Hence, this tax expenditure serves no purpose. Malaysia could still be the centre for excellence in education without giving away its income from tax on the royalty.

For the purpose of tax expenditure analysis, assuming that the government has a valid justification to offer the tax exemption, the financial assistance could be given as direct expenditure, either offered directly to the non-resident franchisor or to the local franchisee so that they can pay higher franchise fees. Nevertheless, the current tax expenditure could ease tax compliance for both the franchisor and the franchisee since they do not need to meet the withholding tax requirement. Unlike some tax expenditures, the cost of this tax expenditure could be easily measured if the government produces a tax expenditure report. Without the cost

[549] Morshidi Sirat, 'Transnational Higher Education in Malaysia: Balancing Benefits and Concerns through Regulations' (Working Paper, National Higher Education Research Institute, October 2005) 10; Anantha Raj A Arokiasamy, 'An Analysis of Globalization and Higher Education in Malaysia' (2011) 1(9) *Australian Journal of Business and Management Research* 73, 73.

[550] Sirat, above n 549, 7; Arokiasamy, above n 549, 77-78.

of the tax expenditure, it is hard to decide upon the best method of meeting the objectives of this outlay.

c. Investment Tax Allowance for Private Higher Educational Institutions Offering Science Courses

Type	Allowance
Brief Description	Investment Tax Allowance of 100% of QCE deductible against 70% of statutory income for 10 years
Reason(s)	To increase the number of local scientists.[551]
Effective Year	2005
Expiry Year	-
Source(s)	• PIA 1986 ss 26G(2), 29H.
Additional Information	- Qualifying science courses are: o Biotechnology o Medical and health sciences o Molecular biology o Material sciences and technology o Food science and technology

The government believes there are positive externalities to having more of its citizens receiving science education. Science experts are regarded by the government as essential in the development of a nation.[552] Therefore, the government is providing financial support to increase the pool of science graduates.

The strategy raises three key policy questions. Is there a shortage of science graduates? If there is a shortage, is it because there are insufficient places to meet demand or is it because there is not enough demand? If there is not enough demand for places, what is the cause?

[551] *Malaysian Budget Speech 2006*, para 74, Appendix 21.
[552] Eileen Ng, 'Boost for Doing Science', *The Star* (online), <http://thestar.com.my/news/story.asp?file=/2012/11/7/nation/12284916&sec=nation>.

A shortage of science graduates means the market has places for more graduates in this field than the universities are producing. If there is no shortage, any attempts to generate further graduates may be misguided. Courses offered in higher education should reflect the need in the workforce and care should be taken to ensure there is neither a supply driven or demand driven (by government encouragement) oversupply of graduates in the area, as was experienced by the country previously with IT graduates.[553] The government must ensure that the increase in the number of science graduates is supported by a similar number of employment opportunities. The positive externalities assumed to flow from more science graduates can only be realised if those graduates find work in their field of specialisation. One problem, of course, is the lag time between education and work. Neither the government nor private sector will know exactly where demand will be in several years' time but training for the demand sectors starts with foundation courses taken some time before in the education cycle. The best the government can do is to provide a full array of courses so students can react quickly as they see areas of demand emerging.

If evidence emerges of a shortage of demand for places in science courses relative to the market need for science graduates, strategies to address the problem should target the causes of the shortage. One factor behind insufficient demand may be the decrease in the number of secondary students to undertake science and mathematics subjects, which limits the potential pool of high school graduates seeking science courses at university level.[554] If this is the problem, the government's efforts would be best directed into finding ways to attract more students into science subjects. If there is a market demand for more science graduates and there is a larger pool of potential applicants as a result of more students studying science in high school, the increase in demand for science courses will eventually increase its supply even without any subsidy to private

[553] Morshidi Sirat *et al*, 'Employability of Graduates in Malaysia', in United Nations Educational, Scientific and Cultural Organization, *Graduate Employability in Asia* (UNESCO, 2012) 24, 34.

[554] Molly Lee, 'Doing More to Attract Science Students', *The Star* (online), 26 February 2012 <http://thestar.com.my/education/story.asp?file=/2012/2/26/education/10776756>; Mageswary Karpudewan, 'Making Science Meaningful', *The Star* (online), 9 December 2012 <http://thestar.com.my/education/story.asp?file=/2012/12/9/education/12398924&sec= education>.

universities. The government's funds can be better utilised by providing scholarships to eligible students. Another possible explanation on the demand side is an information failure that has prevented university applicants from realising the extent of employment opportunities and demand for graduates with science degrees. If this is the problem, the government's efforts would be best directed at addressing the information failure so university applicants realise the potential benefits of pursuing science studies.

If the problem is lack of demand, a strategy based on supply-side programs is unlikely to solve the problem. There is no reason to conclude that if private universities provide more places for science students, there will be greater enrolment in science programs. Nor are subsidy programs to encourage more facilities likely to be taken up if the students are unlikely to materialise. While the cost of creating science facilities can be reduced for private universities with a subsidy, including a tax expenditure, it is not clear that private universities would incur the costs of establishing facilities where the cost is subsidised without certainty that they will have sufficient students who will use the facilities and pay sufficient fees to cover the portion of cost not reimbursed by way of the tax expenditure. There is no reason to assume private universities are willing to take the gamble that students would enrol in science courses only because more courses are offered.

On the other hand, if the evidence shows there is sufficient demand for places to meet the market demand but applicants are turned down because of lack of facilities, strategies should be devised to increase the supply of facilities. Unlike courses in arts and social sciences that require only basic tutorial rooms, lecture halls and the use of computers, science courses often need laboratories equipped with various instruments and equipment. This involves a huge cost that could explain the limited investment in science courses at public universities and the reluctance of private universities to establish science programs. If the cost of educating a science student is very high relative to the salaries paid to science graduates, students will be unwilling to pay for the cost of a science education if the full cost were passed on in higher tuition fees. Some subsidy is needed.

Three subsidy options are available. First, assistance could be provided to private universities by way of an investment tax allowance. Second, assistance could be provided to either private or public institutions, or both private and public universities, by way of grants to cover some of the costs of providing science facilities so tuition fee remains low. Third, assistance could be in the form of scholarships to students wishing to attend private universities to cover higher tuition for science courses. The tax expenditure option can only be targeted at new facilities in private universities. Public universities are generally preferred by students due to their low fees and high quality education. It is not clear that subsidies for private education providers will achieve more increases in higher education science places than the alternative programs and consideration could be given to the alternatives.

d. Investment Tax Allowance for Technical or Vocational Training Institutions

Type	Allowance
Brief Description	Investment Tax Allowance of 100% of QCE deductible against 70% of statutory income for 10 years
Reason(s)	To encourage private sector participation in technical and vocational training program, and to overcome the problem of shortage of labour.[555]
Effective Year	1994
Expiry Year	-
Source(s)	• PIA 1986 ss 26G(1), 29H.
Additional Information	Eligible for new companies that establish technical and vocational training institutions and existing companies in the sector that upgrade their equipment and expand their capacities.

There is no reason to assume universal university education is optimal for all young persons or for the nation's economy. There will be some students better suited to a vocational training than university training. The country requires employees with a broad range of abilities and capabilities. This is where

[555] *Malaysian Budget Speech 1995*, in Malaysia, *Parliamentary Debates*, House of Representatives, 28 October 1994, 6274 (Anwar Ibrahim).

technical and vocational education and training is important to fill the country's need for skilled workers. Unlike university education that focuses on theoretical matters, the emphasis in technical and vocational education is on practical application and hence training institutions are an essential part of the education system.

The government realises the importance of technical and vocational education, and perhaps because the number of technical and vocational institutions is inadequate to meet the demand, the government has introduced this tax expenditure to encourage more private companies to establish these institutions. Since technical and vocational education requires a huge investment in equipment to make sure students can practice skills and have hands-on experience, the government believes these institutions need some kind of government assistance. These institutions are offered the same tax expenditure as private higher educational institutions for the provision of science courses.

This tax expenditure has been offered since 1994. If the number of technical and vocational institutions has reached the desired target, then this tax expenditure should be stopped to avoid an excess in the supply of education. If the target has not been reached, then it is an indication that this tax expenditure has failed to achieve its objective and the government should reconsider its policy.

Assuming that government aid is essential in this area, there are also other measures that can be adopted by the government to achieve a similar result. Direct financial assistance could be provided to the institutions to reduce the burden of high capital investment.

5.3 ENVIRONMENTAL PROTECTION

The commitment from the Malaysian government to environmental protection started in the 1970s and has since then been growing at a slow rate partly due to the fear that any drastic environmental protection regulation could affect the country's industrialisation process and its economic growth.[556] In 2002 the National Policy on the Environment was published by the government, aiming to provide 'continuous economic, social and cultural progress and enhancement of the quality of life on the Malaysians, through environmentally sound and sustainable development'.[557] Among the policy's eight principles, the sixth is to strengthen the role of the private sector in environmental protection and management.[558]

5.3.1 Energy Conservation

Currently the main sources of energy in Malaysia come from oil, gas, coal and hydropower.[559] The first three sources are subject to depletion. Hence, the government promotes energy conservation to reduce wastage of energy. There are two tax expenditures to promote energy conservation. The analysis and discussion of these tax expenditures are combined together.

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[556] Adnan A Hezri and Mohd Nordin Hassan, 'Towards Sustainable Development? The Evolution of Environmental Policy in Malaysia' (2006) 30 *Natural Resources Forum* 37, 40-45; Abdul Raufi Ambali, 'Policy of Sustainable Environment: Malaysian Experience' (2011) 48(3) *European Journal of Scientific Research* 466, 478-479.

[557] Ministry of Science, Technology and the Environment Malaysia, *National Policy on the Environment* (Ministry of Science, Technology and the Environment Malaysia, 2002) 1. The policy can be downloaded at <http://www.doe.gov.my/portal/wp-content/uploads/2010/07/dasar_alam_sekitar_negara.pdf>.

[558] The eight principles of National Policy on the Environment can be viewed at Ministry of Science, Technology and the Environment Malaysia, *National Policy on the Environment*, above n 557, 4-5. They include exercising respect and caring for the environment, conserving natural ecosystems and ensuring sustainable use of natural resources.

[559] Ministry of Energy, Green Technology and Water Malaysia, *Supply Objective* (8 December 2009) <http://www.kettha.gov.my/en/content/supply-objective>.

a. Pioneer Status or Investment Tax Allowance for Companies Providing Energy Conservation Services

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with the exemption of 100% of statutory income derived from promoted activities or promoted products, for 5 years, with eligibility to extend for another 5 years; or Investment Tax Allowance of 100% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To encourage conservation and efficient utilisation of energy.[560]
Effective Year	2000
Expiry Year	2015
Source(s)	• PIA 1986 ss 5(1DB), 6(1AE), 14C, 21H, 26I, 29J. • Promotion of Investments (Promoted Activities and Promoted Products for Selected Industries) Order 2012.
Additional Information	Application for this incentive should be submitted to MIDA.

b. Investment Tax Allowance for Conserving Energy for Own Consumption

Type	Allowance
Brief Description	Investment Tax Allowance of 100% of QCE deductible against 100% of statutory income for 5 years
Reason(s)	To promote conservation of energy among building owners.[561]
Effective Year	2005
Expiry Year	2015
Source(s)	• PIA 1986 ss 26N, 29O.
Additional Information	After 2015, the incentive is still available at the rate of 60% of QCE deductible against 70% of statutory income for 5 years.

[560] *Malaysian Budget Speech 2001*, Appendix 12; *Malaysian Budget Speech 2008*, para 117; *Malaysian Budget Speech 2011*, para 32, Appendix 4.

[561] *Malaysian Budget Speech 2006*, para 111, Appendix 33; *Malaysian Budget Speech 2011*, para 32, Appendix 4.

Given the limited supply of energy from the existing sources, the government realises the importance of energy conservation for the benefit of future generations. Energy conservation would also benefit the environment through reduction in carbon emissions. However, research shows that Malaysian companies lack knowledge and awareness about energy conservation.[562] Besides, energy conservation requires new equipment, and as a result requires additional investment by companies in order to obtain that equipment. Although the companies could benefit from reduced electricity bills, the reduction is not significant compared to the cost of investment. Hence, there is insufficient motivation for the companies to engage in energy conservation. Without government intervention, there may be few companies that would want to voluntarily conserve energy, since at the moment, the cost to conserve energy could be higher to companies than discontinuing involvement in the activity itself. The future costs involving the depletion of energy sources and rehabilitation of the environment are not considered by the companies and are not reflected in the price of products.

Therefore, the government feels the need to offer subsidies through tax allowances to promote energy conservation among companies so that the non-renewable sources of energy (oil, gas and coal) would last longer. Government assistance is required given that the price of energy conservation equipment is relatively high. Nevertheless, other measures are also possible. Several countries, such as Australia, Japan, New Zealand and Switzerland,[563] have introduced a carbon pricing mechanism to penalise those who release the carbon to the environment. This would increase the cost of using electricity and force companies to undertake conservation energy activities to reduce operating costs. Alternatively, the government could provide a grant exclusively for the purchase of energy conservation equipment.

[562] Rahman Saidur *et al*, 'End-Use Energy Analysis in the Malaysian Industrial Sector' (2009) 34 *Energy* 153, 158.

[563] Carbon Finance at the World Bank, *Mapping Carbon Pricing Initiatives: Developments and Prospects* (Ecofys and the World Bank, May 2013) 49-51; 60-66.

5.3.2 Renewable Energy

The best solution to deal with the problem of depletion of energy is to use energy from renewable sources, which are not subject to depletion.[564] In addition, renewable energy such as solar, wind, hydropower and biomass are friendlier to the environment compared to fossil fuels. Malaysia has explored hydropower as a source of electricity since the period before its independence in 1957,[565] but continues to rely to a significant extent on non-renewable energy sources.[566] There are plenty of other sources of renewable energy in Malaysia like solar and biomass that have not been fully utilised. The following are tax expenditures to encourage the generation of energy from renewable sources. The analysis of them is set out after this brief description.

[564] Michael Hübler, Thomas Lontzek and Daiju Narita, *Proposal: The Energy Crisis and Climate Change*, Global Economic Symposium <http://www.global-economic-symposium.org/knowledgebase/the-global-environment/the-energy-crisis-and-climate-change/proposals/the-energy-crisis-and-climate-change-suggested-solutions>.

[565] Zainal Abidin Othman, 'The Future of Hydropower in Malaysia' (May 2005) *Jurutera* 32, 32.

[566] Ong Hwai Chyuan, Teuku Mehrah Indra Mahlia and Masjuki Haji Hassan, 'A Review on Energy Scenario and Sustainable Energy in Malaysia' (2011) 15 *Renewable and Sustainable Energy Reviews* 639, 640-641.

a. Pioneer Status or Investment Tax Allowance for Companies Generating Energy from Renewable Resources

Type	Allowance
Brief Description	Companies are entitled to either of these tax expenditures: Pioneer Status, with exemption of 100% of statutory income derived from promoted activities or promoted products, for 5 years, with eligibility to extend for another 5 years; or Investment Tax Allowance of 100% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To promote renewable energy sources which are environmentally friendly.[567]
Effective Year	2001, with amendments later
Expiry Year	2015
Source(s)	• PIA 1986 ss 5(1DB), 6(1AE), 14C, 21H, 26I, 29J. • Promotion of Investments (Promoted Activities and Promoted Products for Selected Industries) Order 2012
Additional Information	- Eligible sources of renewable are biomass, hydro power (not exceeding 10 megawatts) and solar power.[568] - 'Biomass sources' refer to palm oil mill/estate waste, rice mill waste, sugar cane mill waste, timber/sawmill waste, paper recycling mill waste, municipal waste and biogas (from landfill, palm oil mill effluent, animal waste and others), while energy forms refer to electricity, steam, chilled water, and heat.[569]

[567] *Malaysian Budget Speech 2001*, para 67, Appendix 21; *Malaysian Budget Speech 2003*, para 155, Appendix 34; *Malaysian Budget Speech 2006*, para 108, Appendix 32; *Malaysian Budget Speech 2011*, para 32, Appendix 3.

[568] MIDA, *Environmental Management* <http://www.mida.gov.my/env3/index.php?page=incentives-for-environmental-management>.

[569] MIDA, *Environmental Management,* above n 568.

b. Investment Tax Allowance for Companies Generating Renewable Energy for Own Consumption

Type	Allowance
Brief Description	Investment Tax Allowance of 100% of QCE deductible against 100% of statutory income for 5 years.
Reason(s)	To encourage the development of green technology to ensure sustainable development.[570]
Effective Year	2007
Expiry Year	2015
Source(s)	• PIA 1986 ss 26I (1A), 29J
Additional Information	Application for this incentive should be submitted to MIDA.

In Malaysia, there are only four distributors of electricity to consumers, with each of them having its own designated area.[571] While these distributors produce their own electricity, they also purchase electricity from independent power producers to be sold to consumers. Currently electricity is produced mainly from gas and coal.[572] The government is of the view that the country must utilise its sources of renewable energy to become less dependent on gas, coal and oil, and urges more companies to undertake the activity. In addition, renewable energy also contributes to a better environment. However, it has not been explored by many companies. The only renewable energy that the country is familiar with is hydropower, and all hydropower stations in Malaysia are owned by Tenaga Nasional, the largest electricity distributor and previously a government body which became a company under the government's privatisation policy.

[570] *Malaysian Budget Speech 2011* para 32, Appendix 3.

[571] The largest electricity distributor is Tenaga Nasional, which supplies electricity to Peninsular Malaysia. Other three electricity distributors are Sabah Electricity (supplying to Sabah and Labuan), Sarawak Electricity Supply (supplying to Sarawak) and Northern Utility Resources (supplying to Kulim Hi-Tech Park, a high-technology park located in Kedah, a state in the north of Peninsular Malaysia).

[572] Ministry of Energy, Green Technology and Water Malaysia, *Electricity Supply Industry* (21 February 2013) <http://www.kettha.gov.my/en/content/electricity-supply-industry>.

Generally, the cost to produce energy from renewable sources is higher than generation of energy from fossil fuels. Renewable energy uses new technology, and new technology is more expensive. This could be one of the barriers preventing investment by many companies in renewable energy production. Nevertheless, the government believes that in the long term the cost of not generating renewable energy could be higher. The cost of fossil fuels will continue to increase in the future due to their scarcity. Besides, fossil fuels cause climate change,[573] and the government will incur costs to remedy this. However, the cost to deal with the climate change problem has not been included in the cost of electricity to consumers, which means the government must use the funds of future taxpayers to correct the damage done by today's taxpayers (and non-taxpayers). Hence, the government has decided to intervene and offers incentives to help cover the high initial costs so that more companies will become involved in generating renewable energy with the hope that the anticipated future impacts will be minimised.

Apart from the allowances offered above, there are other measures undertaken by the government to promote renewable energy, including offering import duty and sales tax exemption. In 2011, the government approved the feed-in tariff system, where the distributor companies are obliged to buy renewable energy from approved renewable energy producers at a mandated price.[574]

According to a report, even with the tax allowances, the development of renewable energy in Malaysia has progressed slowly.[575] This could be the reason for introduction by the government of the new feed-in tariff system. If the tariff system can achieve the objective more efficiently, and the current tax

[573] United States Environmental Protection Agency, *Climate Change: Basic Information* <http://www.epa.gov/climatechange/basics/>.

[574] Ministry of Energy, Green Technology and Water Malaysia, *Incentives for Renewable Energy and Energy Efficiency in Malaysia* (September 2009) <http://seda.gov.my/pdf/PTM%20Incentives.pdf>; Sustainable Energy Development Authority Malaysia, *Feed-In Tariff in Malaysia* <https://efit.seda.gov.my/?omaneg=00010100000001010101000100001000000010100001000110&id=1120>.

[575] Tildy Bayar, 'Malaysia Explores Its Renewable Options' (16 September 2011) *Renewable Energy World* <http://www.renewableenergyworld.com/rea/news/article/2011/09/malaysia-explores-its-renewables-options>.

allowances have failed to attract investment by more companies in renewable energy, then the allowances should be removed. Alternatively, the government could offer grants or soft loans to companies to cover the high initial costs. The government could also impose regulations, for example to make it compulsory for all factories to install solar panels.

5.3.3 Allowance for Buildings with the Green Building Index Certificate

Type	Allowance
Brief Description	Allowance of 100% of qualifying expenditure incurred to obtain the Green Building Index (GBI) certificate, deductible against 100% of statutory income for 5 years. Any unutilised allowance can be carried forward to future years until fully claimed.
Reason(s)	To promote construction of buildings using green technology.[576]
Effective Year	2009
Expiry Year	2014
Source(s)	• Income Tax (Exemption) (No. 5) Order 2011
Additional Information	- Qualifying expenditure refers to additional expenditure incurred in relation to the construction of a building, alteration, renovation, extension or improvement of an existing building, or plant or machinery for the purpose of obtaining GBI certificate as certified by the Board of Architects Malaysia. - Given only to the first GBI certificate issued to that building. - Application for the GBI certificate should be submitted to Greenbuildingindex Sdn. Bhd. The company, jointly-owned by the Malaysian Institute of Architects and the Association of Consulting Engineers Malaysia, administrate GBI accreditation. - If the building is disposed of within two years from the date of acquisition, this allowance is withdrawn.

A green building is one that uses less energy, less water and produces less waste, which in overall terms reduces its impact on human health and the building's surrounding environment.[577] To be eligible for the GBI certificate, buildings are assessed based on six key criteria – energy efficiency, indoor environmental

[576] *Malaysian Budget Speech 2010*, para 56, Appendix 4.

[577] Greenbuildingindex Sdn Bhd, *Green Building Index Explanatory Booklet* (February 2012) <http://www.greenbuildingindex.org/Resources/GBI%20Documents/GBI%20Explanatory%20Booklet%202012%2003.pdf>.

quality, sustainable site planning and management, materials and resources, water efficiency and innovation. The cost that needs to be incurred to comply with all these requirements could be significant and therefore the government has decided to provide assistance to companies who wish to make their building GBI certified.

Having a GBI certified building will not only improve the environment, but will also reduce the company's operating costs through savings in electricity and water charges. The value of the building will also increase. Apart from its benefits to the company, the country can also gain from having more GBI certified buildings as they would likely be lesser pollution. Pollution could impose costs on the government in the future through rehabilitation and clean-up of the polluted environment, health problems among the populace, reduction in the number of foreign tourists and loss of foreign investors. Hence the government is willing to spend more now and provide allowances rather than incur higher costs in the future.

Nevertheless, instead of providing assistance through the tax system, assistance delivered through direct expenditure could be more effective. The government can also impose regulations that make it compulsory for all new construction of industrial buildings to be GBI certified.

5.3.4 Tax Exemption on Income Received from the Sale of Certified Emission Reductions Certificate

Type	Tax exemption
Brief Description	Income received from the sale of Certified Emission Reductions (CERs) certificates from approved Clean Development Mechanism projects is exempted from tax.
Reason(s)	Under the Kyoto Protocol, companies that successfully reduce greenhouse emissions are given CERs certificates which can be traded. The tax exemption is given to encourage companies to take part in the project as part of the effort to overcome global warming.[578]
Effective Year	2008
Expiry Year	2012
Source(s)	• Income Tax (Exemption) (No. 8) Order 2008 • Income Tax (Exemption) (No. 2) Order 2010
Additional Information	-

CER refers to gas emission reduction from an activity of a clean development mechanism project in a unit calculated under the Kyoto rules which is equal to one metric tonne of carbon dioxide equivalent.[579] Malaysia does not have to commit to the Kyoto Protocol (which obliged developed countries to reduce emissions of greenhouse gases) because it is a developing country.[580] However, Malaysia can participate in seeking to reduce the emissions of greenhouse gases, and trade the emission reduction as a CER. The CER is traded as a commodity, to be sold to developed countries to help them meet the emission limits set under the protocol. Apart from the company making a profit from the sale of the CER certificate, the country could also benefit from the reduction in the emissions of greenhouse gases that could improve Malaysia's environment. The same set of arguments for government intervention apply to this tax expenditure, namely that the government acts now to avoid worse environmental pollution and other pollution-related problems in the future.

[578] *Malaysian Budget Speech 2008*, para 118, Appendix 34; *Malaysian Budget Speech 2011*, para 32, Appendix 5.
[579] Income Tax (Exemption) (No 2) Order 2010, para 2.
[580] GreenTech Malaysia Berhad, *National Perspective* <http://cdm.greentechmalaysia.my/cdm-malaysia/national-perspective.aspx>.

However, after several years in the market, the trading of CER certificates in the commodity market is a failure. The price has slumped due to excessive supply of new CER in the market while demand remains low.[581] The commodity failure could be the reason why this tax expenditure, which expired in 2012, has not been renewed by the government.

It is undeniable that the reduction of emissions of greenhouse gases is important not only for the country but to the planet as a whole. That is why the United Nations has initiated the Kyoto Protocol, to bring about commitment from most countries in the world. However, if the government really wishes to reduce emissions of greenhouse gases, incentives should not be given based on something so vulnerable as a commodity. The intention should be genuine, to protect the environment, and not for other reasons of profit. The decision not to renew this tax expenditure is a correct one. The previous tax allowances on energy conservation, renewable energy and green buildings have already contributed to reduction of emissions of greenhouse gases.

5.3.5 Accelerated Capital Allowance for Waste Recycling Machinery

Type	Tax deferral
Brief Description	Capital allowance of 60% (40% initial allowance and 20% annual allowance) in the first year, 20% annual allowance in the second year and 20% annual allowance in the third year.
Reason(s)	To promote the development of the waste recycling industry in the effort to reduce environmental pollution.[582]
Effective Year	2001
Expiry Year	-
Source(s)	• Income Tax (Accelerated Capital Allowances) (Recycling of Wastes) Rules 2000
Additional Information	- The plant and machinery is used for recycling of wastes or for further processing of wastes into finished products. - Must be certified by the Ministry of Energy, Water and Communications.

[581] Matthew Carr, 'UN CER Emission Credits Drop as Supplies Advance', *Bloomberg* (online), 2 November 2012 <http://www.bloomberg.com/news/2012-11-02/un-cer-emission-credits-drop-as-supplies-advance.html>.

[582] *Malaysian Budget Speech 2001*, para 66, Appendix 20.

The accelerated capital allowance allows the cost of waste recycling machinery to be deducted in three years. If for accounting purposes the economic useful life of the machinery is more than three years, a tax deferral, which is a tax expenditure, would arise.

Recycling is a process which is undoubtedly important in reducing wastes sent to landfill. The government assistance signals that there are not enough companies involved in the waste recycling industry. It is hard to consider that this is true, since those involved in the recycling industry are believed to earn substantial profits from the business.[583] To ensure a successful recycling campaign, the most important factor is the attitude of households towards recycling.[584] The government should spend more to promote separation of recycling materials at source and to make the separation process easy for households. If everyone participates in recycling, recycling businesses will flourish even without government assistance. If some companies do need assistance, it is better to be given by way of loans. By giving loans, only companies that genuinely require help would receive government assistance, unlike the accelerated capital allowance that can be claimed by all companies including the highly profitable ones.

In addition, it is highly recommended that this type of assistance is provided only for a limited time. An expiry date is essential because once the objective to develop a certain industry has been achieved the assistance should no longer be made available.

[583] Mohd Nasir Hassan *et al*, 'Waste Recycling in Malaysia: Problems and Prospects' (2002) 18(4) *Waste Management and Research* 320, 326.
[584] Hassan *et al*, above n 583, 327.

5.3.6 Accelerated Capital Allowance for Buses Using Natural Gas and Natural Gas Refuelling Equipment

Type	Tax deferral
Brief Description	Capital allowance of 60% (40% initial allowance and 20% annual allowance) in the first year, 20% annual allowance in the second year and 20% annual allowance in the third year.
Reason(s)	To promote the use of Natural Gas for Vehicles (NGV), a cleaner source of energy and one which should reduce air pollution.[585]
Effective Year	1997
Expiry Year	-
Source(s)	• Income Tax (Qualifying Plant Allowances) Rules 1997
Additional Information	- This incentive is available for: o public transport companies on the provision of buses using NGV; o companies that provide NGV refuelling equipment used in an NGV refuelling outlet.

A tax expenditure arises if for accounting purposes, buses and refuelling equipment are depreciated over a period of more than three years. The difference in useful life used in the calculation of accounting depreciation and the accelerated capital allowance for tax purposes would cause a tax deferral.

The use of natural gas by vehicles as an environmentally-friendly source of energy could lead to significantly lower level of pollution, as natural gas releases lower carbon emissions.[586] The cost of natural gas as a fuel for vehicles is also much cheaper compared to petroleum and diesel. However, NGV is not used as widely as petroleum and diesel since few vehicles are produced with NGV engines, and the cost of conversion of existing vehicles so as to be natural-gas compatible is relatively high. Moreover, the number of refuelling outlets is limited. Most of these refuelling outlets are available only in large cities.

[585] *Malaysian Budget Speech 1997*, para 82, Appendix 14.
[586] NaturalGas.org, *Natural Gas and the Environment* <http://www.naturalgas.org/environment/naturalgas.asp>.

While the cost is high, the use of NGV offers substantial benefit as compared with other fuels. Hence, it is sensible for the government to provide a subsidy to encourage the use of NGV. The government in the long run could save on costs to eliminate the pollution of the air. Although the use of NGV will result in lower operating costs due to the cheap natural gas price, it could take a number of years before the cost of conversion could be recovered by companies. Besides, the incentive would ensure that the increase in cost is not transferred to consumers. To ensure a balance between supply and demand of natural gas, the incentive is given not only to promote the use of natural gas, but also to encourage more companies to supply natural gas.

Apart from the accelerated capital allowance, in the 2006 Budget Speech, the government announced a grant of MYR 50,000 (AUD 16,700) for each purchase of a new monogas bus.[587] A year later, a grant of MYR 25,000 (AUD 8,300) was announced for each existing bus converted to NGV.[588] This could be an indication that the accelerated capital allowance given since 1997 is not effective. The availability of both grants and tax expenditure should be more than sufficient to promote the use of NGV. If the promotion is still unsuccessful, it indicates that the cost is not one of the factors that could hinder the use of NGV. The government needs to find the real causes. Nevertheless, both grants ended in 2008, and as at 30 June 2012, the accelerated capital allowance is the only incentive available.

If it is proven that the accelerated capital allowance is ineffective, then it should be discontinued and replaced with a better method of assistance. It is also crucial to find the problems that hinder the use of NGV, and overcome those problems, to ensure the campaign is a success.

[587] *Malaysian Budget Speech 2006*, para 106.
[588] *Malaysian Budget Speech 2007*, para 102.

5.3.7 Accelerated Capital Allowance for Environmental Control Equipment

Type	Tax deferral
Brief Description	Capital allowance of 60% (40% initial allowance and 20% annual allowance) in the first year, 20% annual allowance in the second year and 20% annual allowance in the third year.
Reason(s)	To encourage private sector involvement in environmental protection.[589]
Effective Year	1995
Expiry Year	-
Source(s)	• Income Tax (Qualifying Plant Allowances) (Control Equipment) Rules 1998
Additional Information	- 'Control equipment' includes equipment and facilities used for collecting wastes, for limiting pollution of the environment, for indicating or recording or warning of excessive pollution and for securing more efficient use of the equipment. - Equipment eligible for this incentive is divided into two broad categories – sewerage and industrial effluent treatment plant facilities, and air pollution control equipment.

The above tax rule is given in relation to equipment that could help reduce water and air pollution. It allows the cost of environmental control equipment to be spread over a period of three years. A tax expenditure arises if for accounting purposes the same asset is depreciated over three years.

Just like most social tax expenditures, this is another case where the government wants a company to carry out an activity that benefits the country. Some industrial waste is toxic and hazardous, and could negatively affect the environment and human health. Such waste needs to be properly treated before disposal, and some must be disposed of under specific control.

If companies illegally dump industrial waste and pollute the environment, they could be fined under the *Environmental Quality Act 1974*. Conversely, companies which comply with all the environmental rules and regulations also will incur costs. Either way, companies will incur costs. While it is almost

[589] *Malaysian Budget Speech 1996*, in Malaysia, *Parliamentary Debates*, House of Representatives, 27 October 1995, 59; Appendix 13 (Anwar Ibrahim).

impossible to obtain government assistance to pay fines and penalties, the government offers assistance for the acquisition of environmental control equipment to help reduce the financial burden. The policy to assist these companies is justifiable since the cost of cleaning-up the environment in the future could be higher than the cost of preventing the pollution. More costs will be incurred to treat illnesses caused by the pollution. Nevertheless, if the regulations are effective and all companies are in compliance, companies will invest in environmental control equipment whether or not government assistance is available. The assistance is therefore more likely to obviate the cost of equipment being transferred to consumers, which would result in an increase in prices of goods.

The accelerated capital allowance offered is equivalent to an interest-free loan (as discussed in Section 4.3). If a loan is already in place, the accelerated capital allowance could be effective to support the objective. However, the grant is also a beneficial option that could be more effective. At the same time, rules on environmental protection must be applied strictly to ensure all companies comply with the legislation.

5.4 WELFARE AND SAFETY

Apart from tax expenditures to support human capital development and environmental sustainability, there are also tax expenditures to support welfare and safety among the population.

5.4.1 Welfare

Public welfare is the responsibility of the government; however, in certain cases the government requires private sector participation to achieve its welfare objectives. The government considers that a tax incentive should be granted for companies because the preferred activity (in this case, employment of disabled employees) may not bring any

direct financial benefit to the company, although it could improve the company's goodwill.

a. Double Deduction for Remuneration for Disabled Employees

Type	Double deduction
Brief Description	Remuneration paid by employer to physically or mentally disabled employee can be deducted twice.
Reason(s)	To encourage companies to employ disabled persons.[590]
Effective Year	1981
Expiry Year	-
Source(s)	• Income Tax (Deductions for the Employment of Disabled Persons) Rules 1982. • Petroleum (Income Tax) (Deductions for the Employment of Disabled Persons) Rules 1989.
Additional Information	- To be eligible, the employee must: o Be physically or mentally disabled o Not be able to perform the work of a normal person (with relation to their job)

The double deduction for remuneration for disabled employees is one of the longest-surviving double deduction provisions in the tax legislation. Assuming that the government regularly assesses its tax policy, this could indicate that this tax expenditure successfully meets its objective. However, a closer look at reports in local newspapers reveals that people with disabilities in Malaysia still find it difficult to become employed.[591]

For disabled persons, having a job not only gives them the opportunity to be independent and earn their own living, it also boosts their self-esteem and confidence. Unfortunately, they are always assessed based on their disability rather than their skills. Regardless of how much training they receive, the unemployment rate in this group is still high if perceptions among employers

[590] Singh, *Veerinder on Taxation,* vol 2, above n 540, 776.

[591] 'Golongan OKU Masih Sukar Dapat Pekerjaan', *MStar Online*, 26 September 2010 <http://mstar.com.my/cerita.asp?sec=mstar_berita&file=/2010/9/26/mstar_berita/20100926180019>; 'Majikan Patut Ambil OKU', *Berita Harian* (online), 18 March 2010 <http://www.bharian.com.my/bharian/articles/MajikanpatutambilOKU/Article/cetak>.

cannot be shifted. Hence, the government thinks it needs to take action of some kind to increase employers' motivation to hire disabled persons.

Nevertheless, this tax expenditure is too rigid so that it does not actually support the overall objective to assist disabled persons in becoming employed. When a disabled person wants to get a job, his best chance is to find a job that is not affected by his disability. For instance, a person who has lost a leg should be able to work in customer service and call centres without any difference from a normal person. Although discrimination from potential employers could still exist, his opportunity to get this kind of job is higher. Unfortunately, the double deduction is available only if the employer hires a disabled person who cannot perform the work like a normal person and requires special aid or equipment to do the job. If the person in the previous example works as a pizza delivery driver and needs to use a special motorcycle to perform his job, his employer is entitled to the double deduction.

The rigid tax rule means that the number of employers who can benefit from this tax expenditure is limited. The unavailability of data about how much this double deduction costs the government and how many employers take advantage of this opportunity restricts further analysis on this tax expenditure. Since this tax expenditure has been in place for more than 30 years, it is time for the government to assess its effectiveness. There is a need to formulate a better policy to achieve the goal if it is proven that this tax expenditure is ineffective. Perhaps the government could utilise the double deduction for expenses on approved training for handicapped persons in Section 5.2.1(c) and add a condition that the company must employ the handicapped person to be eligible for the tax expenditure or other government assistance.

5.4.2 Safety

While public security is the responsibility of the government, the security of business premises is the responsibility of companies. However, these two could simply overlap; hence security is a joint responsibility of everyone within the community. Furthermore,

cooperation from the private sector is needed for installation of security and monitoring equipment inside a company's assets or premises.

a. Accelerated Capital Allowance for Security Control and Monitoring Equipment

Type	Tax deferral
Brief Description	Capital allowance of 100 % (20% initial allowance and 80% annual allowance) in the first year.
Reason(s)	To encourage private sector to install security and surveillance equipment as a support to the police force in preventing and eliminating crimes.[592]
Effective Year	2008
Expiry Year	2012
Source(s)	• Income Tax (Accelerated Capital Allowance) (Security Control Equipment and Monitor Equipment) Rules 2008
Additional Information	- Eligible equipment includes: o Infra-red motion detection system o Siren o Access control system o Close circuit television o Video surveillance system o Security camera o Wireless camera transmitter o Time lapse recording and video motion detection equipment o Global Positioning System (GPS) for vehicle tracking

The tax law allows full deduction of the cost of the security control and monitoring equipment in the year of purchase. Under accounting principles, the cost must be depreciated over the equipment's economic useful life. If useful life is more than one year, the accelerated capital allowance causes a tax deferral, and hence a tax expenditure.

Security control and monitoring equipment plays an important role not only in helping police to gather evidence to catch criminals but also in helping to prevent crimes from happening. Its importance can be seen in the recent Melbourne rape

[592] *Malaysian Budget Speech 2008*, para 111, Appendix 31; *Malaysian Budget Speech* 2009, Appendix 24.

and murder case of Jill Meagher in which the video footage from a shop's security camera has given the police the most important clue to find the accused killer which led to the discovery of Jill Meagher's body.[593] Equipment such as the security camera and the alarm system is widely used not only by companies but also in residential houses. The installation of this equipment not only benefits the companies but also the police and the local community as a whole.

It is justifiable for the government to provide financial assistance for companies to invest in security control and monitoring equipment, since security is a joint responsibility for everyone involved. The government is paying for its share of benefits. Instead of giving tax expenditures, a grant or an interest-free loan could also meet the objective, since their costs are more transparent. Since the application to deduct through accelerated capital allowance is much simpler than the application of a grant or loan, the accelerated capital allowance is sensible. Regulation to make it compulsory for all companies to install security control and monitoring equipment could also work; however voluntary participation is preferred.

5.5 ALTERNATIVE CLASSIFICATION FOR SOCIAL TAX EXPENDITURES

This section provides an alternative classification for the social corporate income tax expenditures similar to that which has been done in Section 4.12 for economic tax expenditures. Social tax expenditures are classified based on the government ministry that is responsible for the objective of each tax expenditure. That is, if the tax expenditure is replaced with a direct spending program, this section details the ministry which will handle the relevant program.

[593] 'Meagher Death Prompts Melbourne CCTV Audit', *ABC News*, 30 September 2012 <http://www.abc.net.au/news/2012-09-29/baillieu-announces-cctv-review-in-wake-of-meagher-abduction/4287336>.

5.5.1 Ministry of Higher Education

The responsibility of the Ministry of Higher Education covers all tertiary and post-school education, which includes public and private higher educational institutions, polytechnics and community colleges.[594]

Social Corporate Income Tax Expenditures	Section
1. Tax exemption on royalties received by non-resident franchisor of private institutions of higher learning	5.2.2(b)
2. Investment tax allowance for private higher educational institutions offering science courses	5.2.2(c)

5.5.2 Ministry of Education

The Ministry of Education is in charge of the education system starting from pre-school at the age of four years old through to post-secondary education (equivalent to the A-Levels under the British education system).[595]

Social Corporate Income Tax Expenditures	Section
1. Double deduction for overseas promotional expenses incurred by profit-oriented private and international schools	5.2.2(a)

5.5.3 Ministry of Human Resources

The roles and responsibilities of the Ministry of Human Resources include planning and development of human resources and creation of job opportunities and job placement. The Ministry is also responsible for the syllabus of skills training.[596]

[594] Ministry of Higher Education Malaysia, *Background* <http://www.mohe.gov.my/portal/en/info/introduction.html>.
[595] Ministry of Education Malaysia, *Education System* <http://www.moe.gov.my/v/sistem-pendidikan>.
[596] Ministry of Human Resources Malaysia, *MOHR Roles and Responsibilities* (20 August 2012) <http://www.mohr.gov.my/index.php/en/2012-11-01-21-01-13/roles-and-responsibilities>.

	Social Corporate Income Tax Expenditures	Section
1.	Double deduction for expenses on approved training for employees	5.2.1(a)
2.	Double deduction for expenses on technical training for employees	5.2.1(b)
3.	Double deduction for expenses on approved training for handicapped persons	5.2.1(c)
4.	Double deduction for implementation of structured internship program	5.2.1(d)
5.	Double deduction for participation in overseas career fairs	5.2.1(e)
6.	Investment tax allowance for technical or vocational training institutions	5.2.2(d)

5.5.4 Ministry of Energy, Green Technology and Water

As its name indicates, the Ministry is in charge of the formulation of policies and setting of the direction for the energy, green technologies and water industries.[597]

	Social Corporate Income Tax Expenditures	Section
1.	Pioneer status or investment tax allowance for companies providing energy conservation services	5.3.1(a)
2.	Investment tax allowance for conserving energy for own consumption	5.3.1(b)
3.	Pioneer status or investment tax allowance for companies generating energy from renewable resources	5.3.2(a)
4.	Investment tax allowance for companies generating renewable energy for own consumption	5.3.2(b)

[597] Ministry of Energy, Green Technology and Water Malaysia, *Mission and Vision* (26 August 2010) <http://www.kettha.gov.my/en/content/mission-and-vision>.

5.	Allowance for buildings with the Green Building Index certificate	5.3.3
6.	Tax Exemption on income received from the sale of Certified Emission Reductions certificate	5.3.4

5.5.5 Ministry of Natural Resources and Environment

The Ministry of Natural Resources and Environment is responsible for the country's natural resources management, conservation and management of the environment and shelters, and management of land survey and mapping administration.[598]

	Social Corporate Income Tax Expenditures	Section
1.	Accelerated capital allowance for waste recycling machinery	5.3.5
2.	Accelerated capital allowance for buses using natural gas and natural gas refuelling equipment	5.3.6
3.	Accelerated capital allowance for environmental control equipment	5.3.7

5.5.6 Ministry of Women, Family and Community Development

The welfare and well-being of the disabled community is under the administration of the Department of Social Welfare, an agency of the Ministry of Women, Family and Community Development.[599]

	Social Corporate Income Tax Expenditures	Section
1.	Double deduction for remuneration for disabled employees	5.4.1(a)

[598] Ministry of Natural Resources and Environment Malaysia, *About NRE* (21 February 2013) <http://www.nre.gov.my/English/Profile/Pages/default.aspx>.

[599] Department of Social Welfare, *Pelan Transformasi Jabatan 2011-2015* (28 November 2012) <http://www.jkm.gov.my/index.php?option=com_content&view=article&id=941&Itemid=1387&lang=en>.

5.5.7 Ministry of Home Affairs

Among the 10 main functions of the Ministry of Home Affairs, the first relates to security and public order. The Ministry aims to preserve, maintain and enhance security and public order against any threat, and to enforce internal security and public order.[600]

Social Corporate Income Tax Expenditures	Section
1. Accelerated capital allowance for security control and monitoring equipment	5.4.2(a)

5.6 SOCIAL INCENTIVES NOT REGARDED AS TAX EXPENDITURES

This section identifies tax treatments that are labelled as incentives by the government but are not regarded as tax expenditures in this thesis. For taxation purposes, they are said not to be related to income producing activities and thus under normal circumstances are not deductible. Any provisions that make expenses of non-income producing activities deductible are identified by the government as tax incentives.

On the other hand, these are normal business expenses under accounting practice. Since accounting standards are the benchmark tax base, these expenses are part of the normative tax structure, and hence are not tax expenditures.

5.6.1 Tax Deduction for Pre-Commencement Training and Recruitment Cost

Expenses incurred to recruit employees (such as participation in job fairs and payment to employment agencies or 'head hunters')[601] and expenses incurred to train the

[600] Ministry of Home Affairs Malaysia, *The Main Function of the Ministry* <http://www.moha.gov.my/index.php/en/maklumat-korporat/fungsi-kementerian>.

[601] Income Tax (Deduction of Pre-Commencement of Business Expenses Relating to Employee Recruitment) Rules 2008; IRBM, *Public Ruling No 2/2010 Allowable Pre-Operational and Pre-commencement of Business Expenses* para 10.3.

employees are allowed to be deducted, if they are incurred within one year from the prior to the date of commencement of business.[602]

5.6.2 Tax Deduction for Non-Employee Practical Training

In order to increase the supply of skilled and trained labour,[603] the government gives a tax incentive by way of allowing deduction on expenses incurred to provide practical training to resident individuals who are not employees of the company.[604] The accounting principles recognise this as business expense. To receive practical training, the person must do some work available in the company, and the company receives benefits from him or her. Although the person is not an employee, he or she renders services to the company, and therefore any expenses incurred are business expenses. The incentive makes the tax treatment parallel the accounting treatment, thus it is not a tax expenditure.

5.6.3 Tax Deduction for the Provision and Maintenance of Child Care Centre

Revenue expenditure incurred in the provision and maintenance of a child care centre for employees' children is not related to the income earning process. It is not deductible under tax principles; however, to assist working parents to balance their family and work responsibilities,[605] the government has allowed this expenditure in the form of the deduction.[606] This expenditure is a normal business expense under accounting principles. Therefore it is not a tax expenditure.

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[602] Income Tax (Deduction of Pre-Commencement Business Training Expenses) Rules 1996.
[603] *Malaysian Budget Speech 2002*, para 36.
[604] ITA 1967, s 34(6)(n).
[605] *Malaysian Budget Speech 1996*, in Malaysia, *Parliamentary Debates*, House of Representatives, 27 October 1995, 54 (Anwar Ibrahim).
[606] ITA 1967, s 34(6)(i).

5.6.4 Tax Deduction for Cultural Activity

The government has allowed a tax deduction for expenses incurred to establish and manage a musical or cultural group,[607] and for the sponsorship of any arts, cultural or heritage activity (sponsorship for local activity is limited to MYR 500,000, equivalent to AUD 167,000, and sponsorship for foreign activity is limited to MYR 200,000, equivalent to AUD 67,000).[608] These expenses are not business related for tax purposes, but have been allowed as incentives to promote national cultural and heritage activities.[609] Accounting standards charge these expenses in the income statement as they are not capital expenditure and cannot be capitalised as an asset. Given the similar treatment for both accounting and tax purposes, these incentives are not a tax expenditure.

5.7 SUMMARY

The social corporate income tax expenditures are fewer in number than the economic corporate income tax expenditures, probably because, unlike policies relating to economic objectives that require direct participation by the corporate sector, most policies relating to social objectives are carried out directly by the government. The social tax expenditures relate mainly to objectives that need corporate involvement, such as provision of work experience or reduction of environmental pollution among industries. There are also social tax expenditures that indirectly benefit the national economy, such as the tax expenditures to enhance human capital development which will in the long run produce skilled workers to support economic growth.

The government expects private sector participants to be socially responsible and they are expected to work closely with the government to create a better country. Although social activities do not have a direct link with businesses, they actually could have positive impacts on companies. A dedicated human capital development program will

[607] ITA 1967, s 34(6)(j).
[608] ITA 1967, s 34(6)(k).
[609] *Malaysian Budget Speech 1997*, Appendix 13, *Malaysian Budget Speech 1998*, para 104.

provide companies with a pool of skilled workers and professionals. A clean and pollution-free environment creates better surroundings and healthier employees who can work productively. If companies can realise these benefits, they will voluntarily become involved in the government's social agenda even if no incentives are offered. However, not all companies have social awareness strategies, thus the government needs to take measures to encourage them to participate.

In most cases, the government feels the need to intervene in the market to change companies' behaviour so that they will act in a way that advances the policies favoured by the government. While some of the intervention comes with plausible reasons, there are tax expenditures that were introduced to encourage companies to do things that they will still do even without government intervention. In addition, it appears that several tax expenditures have been left in the system without further review as to whether they are effective, and whether their objectives are still relevant to the current needs of the government.

All of the above tax expenditures can be replaced with government grants or loans. Some objectives could be effectively achieved using regulations. Since no information regarding the measurement of the tax expenditures is available, the analysis of these tax expenditures is restricted and it is difficult to draw definite conclusions in this respect.

CHAPTER SIX

A TAX EXPENDITURE ANALYSIS OF MALAYSIA'S CORPORATE NEGATIVE INCOME TAX EXPENDITURES

6.1 INTRODUCTION

As defined in Section 1.2 (ii), a negative tax expenditure in this thesis means "any tax treatment that deviates from accounting practices and other specified benchmark tax bases, that leads to an increase in tax revenue collected by government". If a tax expenditure is used by the government to encourage certain activities or industries, a negative tax expenditure can be used as a discouragement or deterrence method. A negative tax expenditure is the opposite of a tax expenditure in that, instead of imposing higher tax, the government could impose a similar level of tax to that which applies to others but later charge a penalty or other type of fee as a punishment.

Most research focuses on tax expenditures and analyses how they could be replaced with government direct spending. Although negative tax expenditures are the converse of tax expenditures, they are seldom subject to the same analysis. This chapter identifies corporate negative tax expenditures arising from tax legislation, judicial decisions and administrative practices, based on accounting standards and other elements of benchmark as developed in Section 3.6. These negative tax expenditures are valid as at 30 June 2012. They are then analysed using the conventional tax expenditure analysis, to propose whether the current treatment is appropriate or requires some modification and improvement.

While most negative tax expenditures are intentional and have been introduced for a deliberate reason, often they have been introduced without any explicit objective and it may be difficult to hypothesise a rationale for their existence. In this thesis, negative

tax expenditures are classified based on the known or supposed motive for denial of deduction for the expenses or taxation of the income. The categories and their descriptions are noted below:

1. *Capital nature or non-income related.* The fundamental deductibility rule based on section 33(1) of the ITA 1967 allows only *outgoings and expenses* incurred in the *production of gross income* to be deducted. Therefore capital expenditure and expenses not incurred or related to the production of income cannot be deducted in the calculation of taxable income.

2. *Tax revenue protection.* Some expenses incurred are income in kind to the recipients. As a matter of principle, it is the recipients who should be taxed. Under normal circumstances it is difficult to tax the recipients; hence the denial of deduction is adopted as a surrogate tax, an indirect way of taxing the benefit. This category also covers expenses that are legitimately for business but deductions are restricted to avoid unnecessarily luxurious expenditure being borne by the government.

3. *Discouraging particular expenditures.* These are expenses that are disallowed for deduction to discourage certain activities or to protect public policy.

4. *Timing.* Some expenses are deductible but not in the same period as they are allowed for accounting purposes. The reason for this is the different point of recognition of expenses. While accounting allows for deduction when expenses are incurred, tax rules generally allow for deduction only when payment crystallises.

5. *Additional revenue.* The government charges a higher tax rate on certain income in order to collect more revenue.

Moreover, this chapter also identifies tax treatments that provide a disincentive to companies but are actually part of the benchmark, and thus are not classified as negative tax expenditures.

6.2 TYPES OF CORPORATE NEGATIVE INCOME TAX EXPENDITURES

There are three different types of corporate negative income tax expenditures in Malaysia:

(i) *Deduction not allowed.* This item refers to business expenses that are deductible in the income statement for accounting purposes but are not deductible, or are only partly deductible, in the calculation of taxable income. As a result, taxable income is higher; hence a negative tax expenditure arises.

(ii) *Deferral of deduction.* In accounting, expenses must be matched with revenues generated. Thus, certain expenses, although they have not been paid and the amount is still uncertain, are considered to have been incurred and are deducted in the income statement. These expenses are normally not allowed to be deducted for tax purposes in the same period as in accounting, but rather deductions are granted only when the actual payments are made or liability crystallises (often after the actual amount payable has become certain). Consequently, taxable income is higher in the period in which expenses are incurred.

(iii) *Higher tax rate.* This occurs when tax is calculated at a rate higher than the benchmark. Since the benchmark tax rate is set at 25 per cent, any rate higher than this is a negative tax expenditure.

The following paragraphs show the negative tax expenditures from Malaysia's corporate income tax. Each of them starts with a table that provides brief information regarding the negative tax expenditure – its type, a brief description of it, the reason or motive for the tax treatment, effective and expiry year (if applicable), and its source of law. The table is then followed by discussion as to how the expenditure deviates from the benchmark and hence can be identified as a negative tax expenditure. Finally, the negative tax expenditures are analysed from a tax expenditure perspective to determine whether the chosen mechanism and design is the most efficient way to achieve the intended government objectives (if any).

6.3 CAPITAL NATURE OR NON-INCOME RELATED

The first two tests that an expense must pass to be eligible for deduction are the nature of the expenditure, whether capital or revenue, and the purpose of the expenditure, whether it is for business or personal purposes and whether it is incurred to produce income. Only revenue expenditure incurred in the production of income can be deducted, provided that there is no other provision in the Act that specifically prohibits its deduction. Capital expenditure and expenditure that is not incurred to produce income, even though incurred by business, are not deductible for tax purposes.

6.3.1 Denial of a Deduction for Depreciation of Non-Current Tangible Assets

Type	Deduction not allowed
Brief Description	Accounting depreciation is not deductible for tax purposes but there is a capital allowance regime as a replacement. However, some assets are not covered by the regime, and thus become a permanent loss to the business.
Reason(s)	Accounting depreciation represents allocation of the depreciable amount of an asset over its useful life, and thus is a capital expenditure; hence it is not deductible for tax purposes. Capital allowance is given as a 'concession' or 'relief' for the wear and tear of assets; hence not all assets are selected to receive the concession.
Effective Year	- (Inherited from UK concepts)
Expiry Year	-
Source(s)	• Not covered by ITA 1967 sch 2, 3, 4 and 4A
Additional Information	-

Non-current tangible assets, also known in accounting as property, plant and equipment, are resources that have physical substance and are subjected to wear and tear. They are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and are expected to be used in more than one accounting period.[610] The purchase of a non-current asset is a capital expenditure. In accounting, a

[610] IFRS Foundation, *MFRS 116 Property, Plant and Equipment*, para 6.

capital expenditure is shown on the balance sheet as an asset owned by the business (as compared to revenue expenditure which will be written-off in the income statement). At the same time, yearly depreciation will be written-off on expenses as an allocation of the asset's depreciable amount[611] over its useful life.[612] A similar treatment is applied in taxation, where capital expenditure is not deductible when incurred, but can be recognised over time via the capital allowance system. Although the purposes of the deduction are different (deduction in accounting is to allocate the asset's depreciable amount, while deduction in tax is a compensation for the wear and tear of the asset), an identical result could be achieved if the method of calculation and the asset's useful life are the same.

This section discusses depreciable non-current tangible assets. Intangible assets are not included in the discussion, nor is land, which is a non-current tangible asset but is not subject to depreciation because it has unlimited useful life. Discussion on intangible assets can be found in Section 6.3.2.

There are two issues to be considered. The first is the comparison between the theory and application of capital expenditure in the accounting and tax approaches. The second issue discussed is the difference between the concept of depreciation in accounting and in tax. The main focus of this discussion is on the definition of 'plant' and eligibility to claim a capital allowance.

Although both accounting and taxation distinguish between capital and revenue expenditure, some items considered as revenue expenditure in accounting are treated as capital expenditure in tax. Hence, no deduction is allowed for these expenses. In accounting, capital expenditure refers to money spent on the acquisition of fixed assets[613] or additions to existing fixed assets that will either add to the value or capacity of the asset and will bring future economic benefits to the business. Apart from the cost of the asset, other incidental costs incurred to bring the asset to its useful condition,

[611] MFRS 116, paragraph 6, defines depreciable amount as the cost of an asset, or other amount substituted for cost, less residual value (value at the end of its useful life).

[612] IFRS Foundation, *MFRS 116 Property, Plant and Equipment*, para 6.

[613] The term 'fixed asset' refers to asset that is expected to be used in the business for more than one accounting period.

such as cost of installing machinery, are also deemed capital expenditure.[614] Other factors that can be considered include the materiality of the cost incurred and whether it is a 'once and for all payment' implying that it is a capital item.

Tax legislation does not specify what constitutes capital expenditure. Capital expenditure is distinguished from revenue expenditure based on a series of tests. However, these tests are not based on objective measurements, unlike accounting principles that require assets to be classified as fixed or non-current if they are to be used in the business for more than one year. The following principles have been developed from precedent cases to help identify whether an expense is capital or revenue expenditure.[615] Nevertheless, it should be noted that these tests are merely guidelines, that is, the determination of whether an expense is of a capital or revenue nature depends greatly on the specific factual matrix and judicial interpretation:

(i) *Once and for all test*: A recurring expenditure is considered to be a revenue expenditure whereas a once and for all payment is considered capital expenditure;[616]

(ii) *Enduring benefit test*: A payment made with a view to bringing into existence an asset or an advantage that can give enduring benefit to the business suggests a capital expenditure;[617]

(iii) *Identifiable asset test*: A payment is a capital expenditure if the payment made has resulted in the acquisition of assets of capital nature;[618]

(iv) *Fixed versus circulating capital*: If the expenditure relates to fixed capital, that is, assets that will be used in business to generate profits, this implies a capital expenditure. But if it relates to circulating capital that is, stock-in-trade, then this implies revenue expenditure;[619] and

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[614] IFRS Foundation, *MFRS 116 Property, Plant and Equipment*, para 16.
[615] Singh, *Veerinder on Taxation,* vol 2, above n 540, 636-642.
[616] *Vallambrosa Rubber Co Ltd v Farmer* (1910) 5 TC 529.
[617] *British Insulated and Helsby Cables Ltd v Atherton* (1925) 10 TC 155.
[618] *Tucker v Granada Motorway Services Limited* (1979) 53 TC 92.
[619] *John Smith & Son v Moore* (1921) 12 TC 266.

(v) *Business entity test*: Expenditure that relates to a profit-yielding structure suggests a capital expenditure, whereas expenditure that relates to profit-yielding process suggests revenue expenditure.[620]

Despite several similarities between the characteristics of capital expenditure in accounting and tax, some expenses are treated differently by these two systems. For example, in the case of *CH & Co (Perak)* the compensation paid to a tenant for termination of tenancy has been held to be capital expenditure for tax purposes on the basis that it is a once and for all payment on an identifiable asset, and the payment was made with the intention to make the asset more advantageous and beneficial.[621] In contrast, accounting will treat this expense as revenue expenditure as it does not add value or capacity to the building.

Another example of different outcomes in accounting and tax law is the treatment of assets of small value, such as calculators and electric kettles. In accounting, the initial purchase and subsequent replacement acquisitions may be treated as revenue expenditure based on the concept of materiality. Using the principle of materiality, businesses commonly set a minimum value for an asset to be recognised as a non-current asset. For instance, if the minimum value is set at MYR 3,000 (AUD 1,000), all assets that cost less than this amount can be expensed in the income statement regardless of their expected life,[622] since the cost to provide for depreciation of these assets outweighs the benefit of presenting accurate assets value (given the small value of assets, hence there is only a minimal impact to financial statements). In contrast, under tax practice, these are capital assets and the cost can only be recognised via the capital allowance system (provided they are considered plant and machinery), although legislative changes have moved the tax regime closer to accounting practice in this area. Since 2006, taxpayers have been allowed to deduct the full acquisition price of low cost plant and machinery (assets with a cost of less than MYR 1,000 (AUD 330), subject to a maximum of MYR 10,000, equivalent to AUD 3,300, per year).[623] While accounting

[620] *Sun Newspapers Ltd v FCT* (1938) 61 CLR 337.
[621] *CH & Co (Perak) Sdn Bhd v DGIR* [1989] 1 MSTC 396 (SCIT).
[622] Charles H Gibson, *Financial Reporting and Analysis Using Financial Accounting Information* (Cengage Learning, 11th ed, 2009), 17.
[623] ITA 1967, sch 3A, para 19A.

materiality value is set by the business itself, the tax rule specifies assets valued at less than MYR 1,000 (AUD 330) as not material and which therefore can be expensed immediately. This is not a negative tax expenditure but rather a pragmatic compromise to simplify tax administration.

The immediate expensing rule in tax has limitations. The IRBM has issued a public ruling explaining that neither the new rules nor the general capital allowance rules apply to the initial acquisition of low value items with an expected life of under two years.[624] As a result, the initial cost of acquiring these items cannot be recognised for tax purposes but any subsequent cost of replacement assets may be deducted under the rule.[625] The denial of deduction for the cost of assets with useful life of less than two years is a negative tax expenditure, because under the accounting rule, an asset that is expected to be used in the business for more than one year is categorised as a non-current asset and should be depreciated. There is no plausible explanation for this treatment.

The second issue relating to depreciable non-current tangible assets is the difference between depreciation in accounting and in tax, particularly in respect of assets or benefits that fall outside the narrow definition of qualifying assets in the capital allowance regime. This problem has its genesis in the development of the income tax system in Britain in the 19th Century, when deductions given to capital expenditures were viewed as a mere "concession", as a compensation for the wear and tear of an asset, rather than a right for businesses.[626] The capital allowance is often referred to as 'relief' for capital expenditures. The legislature has the power to decide which capital expenditures can receive the concession. As a consequence, the judiciary takes the view that capital expenditure is not recognised at all unless it is by way of a concession.

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[624] IRBM, *Public Ruling No 1/2008 Special Allowance for Small Value Assets*. Paragraph 3.5 clarified that this new provision is not applicable to assets with expected useful life of not more than two years. Thus the initial cost incurred to purchase a short-life asset is non-deductible capital expenditure, and its replacement cost is deductible revenue expenditure.

[625] As stated in IRBM *Public Ruling No 2/2001 Computation of Initial and Annual Allowances in Respect of Plant and Machinery*, para 3.1.5, assets with life span not exceeding two years are not eligible for capital allowance but are treated under the replacement basis. Assets not falling under the category of small value assets must comply with this rule.

[626] J R Edwards, 'Tax Treatment of Capital Expenditure and the Measurement of Accounting Profit' [1976] *British Tax Review* 300, 318.

In addition, some wasting assets fall outside the capital allowance regime and hence are never recognised for tax purposes. Further, the period of measurement for some assets is substantially out of line with their actual effective life.

On the other hand, depreciation is provided to allocate the money spent on purchase of the asset throughout its useful life, which follows the principle in accounting of the matching concept. Under the concept of matching, expenses must be matched with revenues earned. For example, a truck bought to deliver goods to customers is expected to be used for 10 years. Thus the depreciable amount of the truck is allocated over the 10 years it will be used to generate sales.

FRS 116 *Property, Plant and Equipment*, allows the depreciable amount of non-current assets to be deducted as depreciation in the income statement over the asset's useful life. Assets commonly categorised as property, plant and equipment include land and buildings, plant and machinery, motor vehicles, office equipment, furniture and fixtures. However, land is not depreciated as it has an unlimited useful life, with the exception of land of wasting character, for example, quarries that extract stones such as marble and granite, and gold mines. These types of land will have their value dropped when the minerals and metals contained within the land have been completely extracted.

If there are any significant parts of an item of property, plant or equipment with a different useful life or subject to a different depreciation method, they may be depreciated separately.[627] For instance, a building may last for 50 years but its air-conditioning system must be replaced every 10 years. Thus the building and the air-conditioner must be depreciated separately over their respective useful lives.

Tax legislation provides a similar deduction scheme for wasting assets. This capital allowance scheme is available to all businesses for qualifying expenditure incurred. In brief, the Malaysian capital allowance system consists of the following:

[627] IFRS Foundation, *MFRS 116 Property, Plant and Equipment*, para 43.

(i) Capital allowance for machinery or plant – for machinery and plant used in the business;[628]

(ii) Industrial building allowance – for construction or purchase of an industrial building;[629]

(iii) Mining allowance – for assets and capital expenditure incurred in mining operations;[630]

(iv) Prospecting expenditure – for capital expenditure incurred in searching for and winning access to minerals;[631]

(v) Agriculture allowance – for capital expenditure incurred in agricultural activities, which include clearing and preparation of land, plantation and construction of basic infrastructure on the farm;[632]

(vi) Forest allowance – for construction of roads and buildings used in timber extraction activities.[633]

Despite the various types of capital allowance, there are assets that are left out of the capital allowance scheme. The main issue within the capital allowance for machinery or plant regime is the meaning of the terms 'machinery' and 'plant'. The law does not define these terms. Generally speaking, defining 'machinery' does not pose major difficulties.[634] However, defining 'plant' has caused much confusion. As a consequence, many cases have been brought to court to determine whether an asset is 'plant' and therefore eligible for capital allowance. As a result, in tax law the statutory capital allowance rules apply only to a narrow list of assets. The cost of some wasting assets does not fit into the capital allowance regime and consequently these costs are never recognised for tax purposes. This issue has become a problem not only in Malaysia but in most Commonwealth countries, including the UK and India although, in Australia, the latest reform of the capital allowance regime has substituted the term

[628] ITA 1967, sch 3.
[629] ITA 1967, sch 3.
[630] ITA 1967, sch 2.
[631] ITA 1967, sch 4.
[632] ITA 1967, sch 3.
[633] ITA 1967, sch 3.
[634] Singh, *Veerinder on Taxation,* vol 2, above n 540, 796.

'plant' with 'depreciating asset', which expands the type of assets that are eligible to receive the capital allowance.[635]

Some guidance as to what constitutes 'plant' can be gleaned from judicial decisions. The earliest decision can be traced back to 1887 in *Yarmouth v France*, in which Lindley LJ held:[636]

> There is no definition of plant in the Act; but in its ordinary sense it includes whatever apparatus is used by a businessman for carrying on his business – not his stock-in-trade which he buys or makes for sale, but all goods and chattels fixed or moveable, live or dead, which he keeps for permanent employment in his business

Since then, many cases have been brought by taxpayers seeking to claim a capital allowance on assets which they contend are 'plant'. In the absence of legislative action, the common law has provided the sole definition of the term. These judicial decisions have led to a narrowly-defined term, where many assets have been deemed not to constitute 'plant'. The rules adopted in relation to the definition of 'plant' include:

- an apparatus used for carrying on a business is 'plant'; for example a horse,[637] book[638] and swimming pool of a caravan park;[639]
- a mere part of the setting used for carrying on the business is not 'plant', e.g. electric lamps and fittings[640] and a ship used as a floating restaurant;[641] and
- a shelter to the business is not 'plant', e.g. a canopy at a petrol station[642] and a building of a driving school business.[643]

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[635] Miranda Stewart, 'Capital Allowances for Depreciating Assets: A Successful Reform?' (University of Melbourne Legal Studies Research Paper No 320, 2007) 7.
[636] *Yarmouth v France* (1887) 19 QBD 647.
[637] *Yarmouth v France* (1887) 19 QBD 647.
[638] *Munby v Furlong* (1977) 50 TC 491.
[639] *Cooke v Beach Station Caravans Ltd* (1974) 49 TC 514.
[640] *J Lyons & Co Ltd v Attorney-General* [1944] Ch 281.
[641] *Benson (Inspector of Taxes) v Yard Arm Club Ltd* (1979) 53 TC 67.
[642] *Dixon v Fitch's Garage Ltd* (1975) 50 TC 509.
[643] *MSDC Sdn Bhd v KPHDN* [2001] MSTC 3224 (SCIT).

Determining what can be regarded as 'plant' needs to be assessed individually on a case-by-case basis. 'Plant' can only be defined in the context of the particular industry concerned, and in the particular circumstances of the individual taxpayer's trade. Each case needs to be carefully considered based on the nature of the particular trade being carried on, and how the expenditure incurred is related to the promotion of the trade.[644]

While a building is normally not included as plant, there is a separate capital allowance scheme for an 'industrial building'. Although the term 'industrial building' is defined by the Act,[645] much confusion still arises as to what can be considered an industrial building. Again, it is left for the courts to decide.

The difference in treatment between a capital allowance for taxation purposes and accounting depreciation has not been brought about in order to achieve any social or economic purposes, nor is it to discourage or penalise certain activities. Rather, the capital allowance regime has been inherited from the British tax system and has been accepted in that form.

The IRBM and legislature should consider whether the current practice is appropriate in assessing the real taxable income of a business. There is no clear rationale for permitting a capital allowance only for plant, machinery and industrial buildings (apart from other capital allowance rules that are specific for certain industries). In calculating taxable profits, the legislation allows deductibility of expenses incurred wholly and exclusively in the production of gross income. Tax should be imposed on business taxpayers based on profits calculated using this rule. In accounting, profit is derived after deducting all 'matched' expenses, including depreciation. Depreciation is provided on assets used in the business. There is no doubt that it is incurred in production of gross income. Unfortunately, currently Malaysia's income tax system does not share the same view.

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[644] *CIR v Scottish and Newcastle Breweries Ltd* [1982] BTC 187.

[645] ITA 1967, sch 3, para 63 defines 'industrial building' as a building used in business as a factory, dock, wharf, jetty (and other similar building), warehouse (for public hire), and buildings used in the businesses of water, electricity, telecommunication, farming and mining. Also included as industrial buildings are private hospitals, maternity and nursing homes (para 37A), research buildings (para 37B), hotels (para 37F), airports (para 37G) and motor racing circuits (para 37H).

When a business buys a non-current asset to be used by the business, the money spent is converted into services or benefits brought in by the asset. Thus the 'once and for all' payment made reflects the benefits received for several years. If payment made for the rental of an asset is tax deductible, why then is the depreciation charge on the same asset not a deductible item? Both payments are made to receive services or benefits from assets. At the end of its useful life, a purchased asset will have a reduced value due to wear and tear. By not allowing depreciation for tax purposes, payments made on assets that do not fall within the category of 'machinery' and 'plant' comprise losses to the business and therefore suggest a negative tax expenditure.

An office building may be considered as an example. It is neither plant nor an industrial building, so the purchaser is not entitled to claim a capital allowance for machinery and plant, or as an industrial building allowance. It is common for a business to have an office, and it is clear that the office building is used for business purposes. If a business pays rent for the office premises, the rental payment is tax deductible, but no capital allowance is allowed for purchasing an office building. A business that purchased an office building for its own use or as a rental property therefore is subject to a negative tax expenditure. Implicitly, the government encourages businesses to rent an office instead of purchasing their own office building. This is a strange policy since there is no clear reason for the government to favour rental over purchase of buildings. Office buildings, and all other buildings used for business purposes, should be allowed a capital allowance.

In accounting, there is a clear rule providing for the treatment of payments made for business purposes. If the payment is a revenue expense, it is written-off in the income statement. If it is a capital expense, it is capitalised as a non-current asset and the amount spent will be spread over the asset's useful life by way of depreciation or amortisation. The same principle should be applied in tax to ensure that all business expenditures are entitled to some kind of deduction.

In countries such as Germany and the US, a capital allowance is allowed on non-current assets other than land, at the rate provided by the tax authorities.[646] Although the amount allowed may differ from the accounting depreciation each year, at least the outflow of cash is recognised for tax purposes. Since it is a standard practice to have a different set of capital allowance or depreciation rules for tax purposes instead of using accounting depreciation, it is acceptable for Malaysia to follow the same practice. However, it is desirable that Malaysia's capital allowance regime be revised to include all business assets, so that all such assets are recognised for tax purposes.

6.3.2 Denial of a Deduction for Amortisation of Intangible Assets

Type	Deduction not allowed
Brief Description	Acquisition of intangible assets is not deductible.
Reason(s)	Capital expenditure, but no capital allowance scheme available.
Effective Year	- (Inherited from UK concepts)
Expiry Year	-
Source(s)	• Not covered by ITA 1967
Additional Information	A limited number of tax expenditures for intangible assets are available, given as accelerated capital allowances and double deductions.

An intangible asset is a non-monetary asset that has no physical substance but has value and brings advantage to a business. Examples include goodwill, brand names, proprietary rights (patents, trademarks, copyrights), secret recipes, trade secrets, know-how, licences and computer software. Both accounting and taxation treat costs incurred on intangible assets as capital expenditure. Similar to the treatment of tangible assets, accounting standards require the costs of acquisition of an intangible asset to be allocated over its useful life. Unfortunately, there is no capital allowance scheme for intangible assets, and as a result the costs of acquisition of most intangible assets are not recognised for tax purposes.

[646] CCH, *International Master Tax Guide 2009/10*, 6th ed, DEU ¶1-100; USA ¶1-100.

The accounting treatment for intangible assets is set out in MFRS 138 *Intangible Assets*. Generally, an intangible asset should be amortised over its useful life and tested for impairment,[647] and the amortisation and impairment loss are recognised as expenses in the income statement.[648] If the intangible asset has an indefinite useful life, no amortisation is to be provided. Instead it will be tested for impairment annually, or more frequently if necessary.[649]

In Malaysia, capital expenditure is not tax deductible. Unlike tangible assets that give rise to entitlement to capital allowances, tax legislation provides no allowance for intangibles. However, there are certain intangible assets where costs can be deducted under tax incentives announced by the government. They are regarded as tax expenditures to encourage certain activities (because the incentives given are in terms of accelerated capital allowance and double deduction), and are discussed in Chapter Four.[650]

Expenses incurred to restrain competition, such as settlements with competitors and restrictive covenants,[651] are intangibles that have been denied deduction by judicial precedent.[652] They are capital in nature under judicial concepts on the basis that they result in an enduring advantage to the company (one of the key tests used by the courts to identify 'capital' outlays for tax purposes). Although no recent Malaysian case can be found regarding this issue, a Malaysian court has confirmed that a payment made to restrict or prevent competition is capital in nature in terms of judicial understanding of capital outlays.[653] A public ruling has also listed 'securing an enduring advantage for a

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[647] An impairment loss arises when the carrying amount of an asset exceeds its recoverable amount. In other words, it means the value of the asset has fallen.

[648] IFRS Foundation, *MFRS 138 Intangible Assets*, paras 74-75, 97-106.

[649] IFRS Foundation, *MFRS 138 Intangible Assets*, paras 107-108.

[650] See Chapter Four on tax expenditures relating to Accelerated Capital Allowance for the Cost of Acquisition of Proprietary Rights of Manufacturing Companies (Section 4.4.17), Accelerated Capital Allowance for Franchise Fee (Section 4.8.9), Accelerated Capital Allowance for the Registration of Patent and Trademark [Section 4.11.2(c)], Accelerated Capital Allowance for ICT Equipment [Section 4.10.1(b)], and all tax expenditures related to Research and Development Costs (Section 4.9).

[651] In Malaysia restrictive covenants are generally void, except in three situations (Contracts Act 1950, s 28).

[652] *Associated Portland Cement Manufacturers Ltd v Kerr* (1945) 27 TC 103; *Walker v The Joint Credit Card Co Ltd* (1982) 55 TC 617.

[653] *KPHDN v Dato' Hanifah Noordin* [2003] MSTC 4007 (High Court of Malaya).

trade or business' as a non-deductible expense.[654] Consequently, money paid on these expenses is never recognised for tax purposes. In accounting, they are identifiable intangible assets and are subject to deduction rules under MFRS 138.

The costs of intangible assets are capital expenditure in taxation based on several characteristics used by courts to identify capital outlays under judicial concepts. Yet, they are not regarded as business assets. The general tax treatment of costs incurred on intangible assets is that they will become a permanent loss for a business as no capital allowance scheme is available; hence they give rise to a negative tax expenditure. Although there are a small number of intangible assets the cost of which can be deducted, they are not viewed as intangibles but rather as individual expenses that the government considers need encouragement. Analysis in this part covers the general tax treatment of intangible assets.

Similar to the treatment based on accounting principles, the cost of intangible assets is a capital expenditure in taxation and therefore cannot be deducted as an ordinary business expense. However, while accounting allows the cost to be amortised over the asset's useful life, no similar treatment is proposed for calculation of tax. Although they are intangibles, they are still assets that are used in the business and bring benefits to the company, thus should be treated equally. In fact, the importance of intangible assets in today's business world is increasing, and it has been identified as one of the new sources of growth.[655]

Therefore, it is strongly suggested that a capital allowance deduction scheme similar to the amortisation for intangible assets in accounting be introduced into Malaysia's corporate income tax system. The current tax policy provides a disadvantage to such an important investment. Many countries, including India,[656] China,[657] the Netherlands,[658]

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[654] IRBM, *Public Ruling No 6/2006 Tax Treatment of Legal and Professional Expenses*, para 6.8.

[655] OECD, 'Sources of Growth', in *OECD Science, Technology and Industry Scoreboard 2011* (OECD Publishing, 2011) <http://www.oecd-ilibrary.org/science-and-technology/oecd-science-technology-and-industry-score board-2011_sti_scoreboard-2011-en> 20, 24-25.

[656] CCH, *International Master Tax Guide 2009/10,* above n 646, IND ¶1-100; India's Income Tax Act 1961 s 32(1)(ii).

[657] CCH, *International Master Tax Guide 2009/10,* above n 646, CHN ¶1-100.

[658] CCH, *International Master Tax Guide 2009/10,* above n 646, NLD ¶1-100.

New Zealand,[659] Japan[660] and the US[661] have provided a capital allowance or similar deduction to intangible assets (although not all intangible assets are eligible). Some countries, such as Ireland, have even accepted the accounting amortisation for intangible assets for deduction.[662] Malaysia could do the same. It is not only that the current tax policy could impede foreign investment, it is also an unjust policy to businesses that rely heavily on intangible assets.

6.3.3 Denial of a Deduction for Interests and Other Borrowing Costs

Type	Deduction not allowed
Brief Description	Deductibility depends on the purpose for which the loan has been taken out. If the fund is acquired to finance something not related to income producing activities, then its borrowing costs would not be deductible.
Reason(s)	Not related to income producing activities.
Effective Year	- (Incorporated in ITA 1967 when enacted)
Expiry Year	-
Source(s)	• ITA 1967 s 33(1)(a) • *KPHDN v Seabanc Kredit Sdn Bhd* • *FCD Sdn Bhd v KPHDN* • *BDHDSB v KPHDN* • IRBM Public Ruling No 2/2011 Interest Expense and Interest Restriction • IRBM Public Ruling No 6/2006 Tax Treatment of Legal and Professional Expenses
Additional Information	-

In dealing with borrowing costs, accounting standards need to consider whether the costs are directly attributable to the acquisition, construction or production of a qualifying asset. Accounting standards define a qualifying asset as 'an asset that normally takes a substantial period of time to get ready for its intended use or sale'.[663]

[659] CCH, *International Master Tax Guide 2009/10,* above n 646, NZL ¶1-100.
[660] CCH, *International Master Tax Guide 2009/10,* above n 646, JPN ¶1-100.
[661] CCH, *International Master Tax Guide 2009/10,* above n 646,USA ¶1-100.
[662] Irish Tax and Customs, 'Intangible Assets Scheme under Section 291A Taxes Consolidation Act 1997' (2010) 9 *Tax Briefing* <http://www.revenue.ie/en/practitioner/tax-briefing/archive/2010/no-092010.html>; Ireland's *Taxes Consolidation Act 1997*, s 291A.
[663] IFRS Foundation, *MFRS 123 Borrowing Costs,* para 5.

Examples include the construction of a building (either for own use or for a customer), intangible assets, and the production of inventories that take a substantial period of time to bring to a saleable condition.[664] If they are directly attributable to such assets, then the costs need to be capitalised to the cost of the asset. If they are not (and generally they will not be), then they will be written-off in the income statement.

Tax legislation, however, requires a detailed examination of the purpose for which funds are utilised to decide whether they are revenue or capital in nature. If the funds borrowed are related to income producing activities, such as the purchase of machinery or construction of a factory for own use, then interest incurred would be tax deductible.[665] If the project adds to the capital structure of the taxpayer, then the loan is considered as capital in nature, and so are all costs associated with it. Moreover, the courts have also provided guidelines to determine the nature of a loan.[666] The starting point is to ascertain the precise purpose of taking out the loan. Without this test, all loans can simply be regarded as an addition to capital structure. To be viewed as revenue, there must be a sufficient linkage between the loan and the main transaction or project for which the loan was taken out. If a sufficient linkage exists, the next step is to examine whether the main transaction or project in question is of a capital or revenue nature.

Accounting standards deem 'borrowing costs' to cover a wide range of loan-related expenses. By contrast, borrowing costs are treated and defined more narrowly for tax purposes. Based on accounting standards, the term 'borrowing costs' refers to all expenses related to the process of obtaining the loan, which includes interest and other costs that an entity incurs in connection with the borrowing of funds. It may include interest expenses calculated using the effective interest rate method,[667] finance charges in respect of finance leases, and exchange differences arising from foreign currency

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[664] Jane Lazar and Huang Ching Choo, *Financial Reporting Standards for Malaysia* (McGraw-Hill, 2nd ed, 2008) 350.

[665] *ITA 1967*, s 33(1)(a); IRBM, *Public Ruling No 2/2011 Interest Expense and Interest Restriction*, para 5.1.

[666] *Comptroller of Income Tax v IA* [2007] MSTC 7,549 (Court of Appeal of Singapore).

[667] This is the effective interest rate method as described in MFRS 139 *Financial Instruments: Recognition and Measurement*, para 9. It is the rate that exactly discounts future cash payments or receipts through the expected life of the financial instruments, or in a shorter period when appropriate.

borrowings to the extent that they are regarded as an adjustment to interest costs.[668] It also includes ancillary costs such as amortisation of financing fees or charges. Conversely, in accordance with section 33(1)(a) of the ITA 1967, the tax legislation only allows deductions on interest, and is silent on the question of the deductibility rules for other loan-related expenditure. As a result, the deductibility of other borrowing costs depends on judicial characterisation of the expenditures as capital or revenue outgoings. Earlier cases characterised the costs as capital expenses and, in the absence of any capital allowance regime for this category of expenditures, they were never deductible. However, a shift in the approach taken by courts more recently has led to the characterisation of these expenses as part of the loan package similar to interest incurred on the loan.

In general, accounting standards treat borrowing costs as periodic costs that should be recognised as an expense in the period in which they are incurred. This means that they should be written-off in the income statement when payment to the lender is due. A different treatment is applicable for borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset, where the costs must be capitalised so as to be included as part of the cost of the asset.[669] Capitalisation will start when the work on the asset commences, and expenses on the asset and borrowing costs have been incurred.[670] Capitalisation shall cease when all the activities to prepare the asset for its intended use or sale have been substantially completed.[671]

Usually, interest incurred on money borrowed to be employed in the production of income and for assets used to produce income will be allowable. Although interest payments on loans are usually deductible,[672] other expenses related to the borrowing process are sometimes not deductible. In the *Seabanc Kredit* case, it was held that when a loan is characterised by a court as a transaction on capital account using the judicial characterisation tests, all ancillary expenses incurred to enter into the loan

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[668] IFRS Foundation, *MFRS 123 Borrowing Costs,* para 6.
[669] IFRS Foundation, *MFRS 123 Borrowing Costs,* para 8.
[670] IFRS Foundation, *MFRS 123 Borrowing Costs,* para 17.
[671] IFRS Foundation, *MFRS 123 Borrowing Costs,* para 22.
[672] *Fernrite Sdn Bhd v KPHDN* [2004] MSTC 4065 (High Court of Kuala Lumpur); *Rakyat Berjaya Sdn Bhd v KPHDN* [1999] MSTC 3731 (High Court of Sabah and Sarawak).

including loan processing fees, legal fees, loan management fees, stamping fees, guarantee fees, facility fees, arrangement fees and commitment fees are treated as capital outgoings.[673] This has been further clarified by the IRBM in Public Ruling No 6/2006 *Tax Treatment of Legal and Professional Expenses*. Included in the list of non-deductible expenses are legal and professional expenses incurred to obtain new loan or credit facilities,[674] and to renew a loan taken to raise additional capital.[675] A deduction for legal fees is allowed only for the renewal of loans taken by financial institutions.[676] As there is no statutory rule that will allow a taxpayer to depreciate these expenses or recognise them as part of the cost base for any asset, they become the equivalent of 'black hole' expenses, never recognised for tax purposes. In contrast, all these expenses would be deductible for accounting purposes, either immediately when incurred or through depreciation (for borrowing costs that are capitalised). Furthermore, the Court in the *Seabanc Kredit* case has held that the obtaining of loans was a step preparatory to the earning of income, and therefore not wholly and exclusively incurred in the production of income.

However, deduction of a guarantee fee was allowed in *FCD Sdn Bhd v KPHDN* on the basis that, for a housing developer, obtaining syndicated loans is part of the nature of its business and will increase its trading stock.[677] Thus, it is revenue in nature. Like interest, the guarantee fee was an integral part of the loan package and should be treated similarly. A similar decision was held in a recent case concerning the deductibility of underwriting and guarantors' commissions, an agency fee, amount review fee, annual management fee, and surveillance fee. They are all revenue expenditure and deductible, because they are part of the loan package and have the same characteristics.[678] In Singapore, the Court of Appeal reached the same outcome.[679] Nevertheless, based on its public ruling, the IRBM seems to consider that no linkage exist for loans taken by a trading or commercial company.[680]

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[673] *KPHDN v Seabanc Kredit Sdn Bhd* [1998] MSTC 3695 (High Court of Malaya).
[674] IRBM, *Public Ruling No 6/2006 Tax Treatment of Legal and Professional Expenses*, para 6.8.
[675] IRBM, *Public Ruling No 6/2006 Tax Treatment of Legal and Professional Expenses*, para 6.2.
[676] IRBM, *Public Ruling No 6/2006 Tax Treatment of Legal and Professional Expenses*, para 5.2.
[677] *FCD Sdn Bhd v KPJHDN* [1995] 2 MSTC 2,181 (SCIT).
[678] *BDHDSB v KPHDN* [2011] MSTC ¶10-017 (SCIT).
[679] *Comptroller of Income Tax v IA* [2007] MSTC 7,549 (Court of Appeal of Singapore).
[680] IRBM, *Public Ruling No 6/2006 Tax Treatment of Legal and Professional Expenses*, para 6.2.

While the revised MFRS 123 requires capitalisation of borrowing costs for construction contracts, the decision in the case noted above allows these costs to be deductible on the basis that they are related to trading stock and therefore are revenue expenditure. However it should be noted that, at the time of the *FCD* case, accounting standards permitted companies to choose between capitalisation of borrowing costs and immediate write-off. Therefore, although this treatment differs from accounting standards, it is not a negative tax expenditure. Based on accounting principles, both treatments are acceptable. Besides, the purpose of the revision to the accounting standard was to conform to the US standard as part of the convergence program between the IASB and the US Financial Accounting Standards Board.[681]

As there are only two options - deductible or not deductible - taxpayers will always prefer the first option. It is therefore suggested that the tax treatment of borrowing costs should be extended to include capitalisation. This treatment may be more appropriate in certain situations, for example interest on money borrowed for the purpose of acquiring inventory, interest on loans taken out to finance capital expenditures where no asset is acquired or produced but that create long term benefits, and interest on loans acquired to purchase non-current assets.[682] Borrowing costs will be included as part of the qualifying plant expenditure for the purposes of a claim for a capital allowance. In the case of inventory, the interest should be deductible in the year of sale, which will follow the matching and ability-to-pay principles.[683]

IRBM public rulings on Construction Contracts[684] and Property Development[685] have explained that interest paid and payable on a loan to a construction contractor or property developer to finance the works carried out in relation to a construction contract

[681] IASB, 'IASB Issues Amendments to the Requirements for Borrowing Costs', *Press Release* (29 March 2007) <http://www.ifrs.org/News/Press+Releases/IASB+issues+amendments+to+the+requirements+for+borrowing+costs.htm>.
[682] Brian J Arnold, 'Is Interest a Capital Expense?' (1992) 40 (3) *Canadian Tax Journal* 533, 550–551.
[683] Arnold, above n 682, 550.
[684] IRBM, *Public Ruling No 2/2009 Construction Contracts.*
[685] IRBM, *Public Ruling No 1/2009 Property Development*.

is a direct expense and part of the construction cost.[686] Thus, under these circumstances, any interest expense must be capitalised. The same rulings also specify that a guarantee fee in respect of a loan is a capital cost of raising funds and is not deductible.[687] The rulings clearly show that the current practice accepted by the IRBM is to recognise interest for tax purposes but not other ancillary expenses incurred to obtain loans. However, the rulings are pertinent to construction contractors and property developers only. Other interest expenses are still subject to the general deductibility rule, including interest on a loan taken out to finance the construction of a company's own building.[688]

In a recent Malaysian case, *KPHDN v Success Electronics and Transformer Manufacturer Sdn Bhd*, the High Court supported SCIT's decisions that the tax treatment of interest incurred on a loan should follow financial accounting practice.[689] If the interest was capitalised and absorbed as a cost, then it is deemed to be capital expenditure and hence gives rise to entitlement to the reinvestment allowance.[690] However, if the interest was expensed for accounting purposes, it may also be deductible in the calculation of taxable income and the taxpayer would therefore not be entitled to the allowance. Nevertheless, it should be noted that this case deals with the eligibility to Reinvestment Allowance under Schedule 7A of the ITA 1967.

In this case, accounting practice was accepted as the appropriate tax treatment of interest on loans. Thus, there is no negative tax expenditure for borrowing costs incurred on qualifying assets. However, disincentives may still exist on other borrowing costs that require immediate write-off under accounting standards. Borrowing costs, whether recurring expenses like interest payments or one-off payments like the guarantee fee, are business expenses. If they are capital expenditure,

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[686] IRBM, *Public Ruling No 2/2009 Construction Contracts*, para 11.4.4 and IRBM, *Public Ruling No 1/2009 Property Development*, para 11.4.3.

[687] IRBM, *Public Ruling No 2/2009 Construction Contracts*, para 11.9 and IRBM, *Public Ruling No 1/2009 Property Development*, para 11.13.

[688] IRBM, *Public Ruling No 2/2011 Interest Expense and Interest Restriction*, para 5.1. See also Example 3 in that paragraph.

[689] *KPHDN v Success Electronics and Transformer Manufacturer Sdn Bhd* [2012] MSTC ¶30-039 (High Court)*; SETM Sdn Bhd v KPHDN* [2010] MSTC ¶10-000 (SCIT).

[690] Reinvestment allowance is a tax incentive given on capital expenditure incurred on qualifying projects for expanding, modernising and automating existing business.

they should be amortised over the life of the asset or loan. Denying their deductibility will affect taxable profit. This suggests that the tax payable has been overcharged, hence giving rise to a negative tax expenditure.

The acquisition of a loan is a common source of financing in the running of a business. Not everyone has sufficient personal funds to finance a business, and not all companies, especially SMEs, can raise funds through issuance of shares. Compared to utilising personal funds, there are associated costs involved in acquisition of a loan. The main cost is interest. There are also other one-off costs such as legal fees, stamping fees and management fees. Whether these costs are deductible for tax purposes, and also whether they can be capitalised into the cost of asset, generally depends on the purpose for which the funds obtained from the loan are to be used. If the loan is obtained to add to capital structure, or has no nexus to income producing activities, the borrowing costs are not deductible, and cannot be capitalised either. This is a permanent loss to a business. This treatment does not support any government objectives but is actually the result of judicial interpretation of the deductibility rule for taxation purposes that specifies that deductible expenses are those that are 'wholly and exclusively incurred in the production of gross income'.[691] Indirectly, the government allows businesses to acquire a loan if they wish to expand their operations, but does not provide support if the loan is taken out to pay tax, even in the case of a business which has cash flow problems in paying tax and needs to take out the loan to avoid incurring a penalty. It would also mean that it is preferable for the business to sell assets rather than acquire a loan.

Most of the above cases that allow deductibility of other borrowing costs involve companies that require the construction or purchase of a building in their ordinary business (construction company, property developer, property letting company), in which there is a clear nexus between the loan acquired and the nature of the business. In accounting, all types of companies can deduct their borrowing costs, either when incurred or through depreciation. It is proposed that tax legislation should provide for equal treatment of all types of companies. Assessing this through the framework of tax

[691] ITA 1967, s 33(1).

expenditure analysis, there is no reason for the government to discourage companies from financing their businesses using external funds. This is normal practice necessary to ensure the sustainability of businesses. As such, the costs incurred should be allowed as deductions, either as immediate write-offs or spread over a few tax periods through depreciation or amortisation.

6.3.4 Denial of a Deduction for Pre-Commencement and Pre-Operational Expenditure

Type	Deduction not allowed
Brief Description	Except for a number of expenses allowed for deduction as tax incentives, the general rule is that expenses incurred before the commencement of operations or business are not deductible.
Reason(s)	Not wholly and exclusively incurred in the production of gross income.[692]
Effective Year	- (Inherited from UK concepts)
Expiry Year	-
Source(s)	• IRBM Public Ruling No 2/2010 *Allowable Pre-Operational and Pre-Commencement of Business Expenses*
Additional Information	-

Pre-commencement and pre-operational expenditure refers to expenses that have been incurred before the business starts its actual operation (not the date of incorporation of business). Usually they consist of expenses incurred to form the business and to prepare the business for operation, such as legal fees, costs of preparing memorandum and articles of association, costs of conducting market research and recruitment expenses. Under taxation principles, expenses incurred before commencement of business operations, that is, before the income-earning activity starts, are not deductible for tax purposes as they are part of the initial outlay and are not incurred to produce income.[693] Moreover, these are one-off payments that would normally be treated as capital expenditure under tax principles. Yet, some of these expenses are allowed to be

[692] IRBM, *Public Ruling No 2/2010 Allowable Pre-Operational and Pre-Commencement of Business Expenses*, para 3.1.

[693] IRBM, *Public Ruling No 2/2010 Allowable Pre-Operational and Pre-Commencement of Business Expenses*, para 3.1.

deducted in the first year the business commences as incentives. These expenses are briefly discussed in Section 4.13(i) but are not classified as tax expenditures since they conform to accounting practice.

In accounting, pre-commencement and pre-operational expenses are revenue expenditure. Before 2001, many companies treated these expenses as similar to intangible assets, where they are capitalised in the balance sheet as an asset and amortised in the income statement for a number of years. Since then, the Malaysian accounting standards body has clarified this matter through the issuance of IC Interpretation 201 *Preliminary and Pre-Operating Expenditure*.[694] As these expenses do not meet the criteria for recognition of assets, either tangible or intangible, they cannot be shown as an asset in the balance sheet and hence must be expensed as incurred. An asset must bring future economic benefit to the business, but pre-operational and preliminary expenses, which normally consist of legal and administrative costs, have no economic benefit. Therefore they cannot be classified as an asset and should not be capitalised and amortised.

If capital expenditure is incurred prior to commencement of a business, accounting principles provide for depreciation once the asset is available for use in the business.[695] Therefore, interest expense incurred before commencement of a business for the construction of a building should be capitalised as a cost of the building and allowed for in depreciation. Tax has taken a different approach. As mentioned in one of the IRBM public rulings, interest expense incurred on construction of a building prior to commencement of business is not deductible.[696] If the interest is capitalised in the cost of the building, it must be excluded from the calculation of the capital allowance. However, the cost of the building would still be eligible for a capital allowance. It is only the interest component that is denied deduction, probably because interest is treated as a revenue expense and, as with other pre-commencement revenue expenses, is not deductible.

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[694] The purpose of IC Interpretation is to provide guidance regarding specific accounting treatment.
[695] IFRS Foundation, *MFRS 116 Property, Plant and Equipment*, para 55.
[696] IRBM, *Public Ruling No 2/2011 Interest Expense and Interest Restriction*, para 5.2.

Denying deductibility for pre-commencement expenditure is a permanent loss and hence suggests a negative tax expenditure. The loss could be substantial in circumstances such as a property letting company in Singapore that builds a shopping mall with the intention of receiving income from tenancies.[697] All expenses incurred before the building receives a 'temporary occupation licence' are considered as pre-commencement expenditure, because the income earning activity will start only after the licence is granted. Among expenses that cannot be deducted are marketing expenses which, in accounting, can be written off as ordinary expenses. The nature of the business requires marketing expenses to be incurred before construction is completed, and denying a deduction seems unfair.

The denial of deduction has no nexus with government's social and economic policies. It is also unlikely that the government is seeking to discourage pre-commencement expenditure. This is just a strict application of the rule in section 33(1)(a) that expenses and outgoings be "wholly and exclusively incurred in the production of gross income". The absurdity of this treatment can be seen from one example in a public ruling relating to a company in the business of supplying electricity.[698] Interest incurred during the construction of the power plant, incurred prior to the commencement of business to supply electricity, is not deductible. To supply electricity, the company needs a power plant. Without a power plant, no electricity can be produced, therefore none can be supplied. Obviously a power plant is needed to produce income. In contrast, if a company purchases an existing power plant and commences electricity production immediately, interest incurred on a loan taken out to purchase the power plant is deductible.

The legislature could have identified this issue and hence allowed as a deductible item several types of pre-commencement expenditure.[699] These deductions, however, can be enjoyed only by certain businesses. It is therefore proposed that all pre-commencement and pre-operational expenditure be allowed to be deducted in the first year of operation, as practised in accounting.

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[697] *T Ltd v Comptroller of Income Tax* [2007] MSTC 7,609 (Court of Appeal of Singapore).
[698] IRBM, *Public Ruling No 2/2011 Interest Expense and Interest Restriction*, para 5.2, example 4.
[699] See Section 4.13.1, Tax Deduction for Pre-Commencement and Pre-Operational Expenses.

6.3.5 Denial of a Deduction for Post-Cessation Expenditure

Type	Deduction not allowed
Brief Description	Expenditure incurred after cessation of business is not deductible.
Reason(s)	Not wholly and exclusively incurred in the production of gross income. Cessation of business does not produce income.[700]
Effective Year	- (Inherited from UK concepts)
Expiry Year	-
Source(s)	• *Godden v A Wilson's Stores (Holdings) Ltd* • *Amalgamated Zinc (de Bavay's) Ltd v FCT* • *Ampat Tin Dredging Ltd v DGIR* • *H Rubber Estates Bhd vs DGIR*
Additional Information	-

In calculating taxable income, no deduction is allowed for expenditure incurred after the cessation of business, on the basis that this expenditure is not related to income producing activities.[701] If the business is still continuing but one of its operations has shut down, expenses relating to that particular operation are not deductible because it now has no source of income.[702] For an expense to be allowable, it must be incurred to 'enable it to carry on that business and to produce income'.[703]

Accounting adopts a contrary approach. Accounting principles regard these expenses as ordinary expenses. All expenses, including expenses incurred to close down a business, are treated in a similar way to other normal expenses for accounting purposes. These expenses are written-off in the income statement to arrive at the net profit. Accounting standards require results from a discontinued operation to be presented separately from the continuing operations.[704] This is designed to ensure that users can evaluate the

[700] *Ampat Tin Dredging Ltd v DGIR* [1982] 2 MLJ 46 (High Court of Malaya).
[701] *Godden v A Wilson's Stores (Holdings) Ltd* (1962) 40 TC 161. In this case, the payment was ruled not deductible because the payment was 'not made for the purposes of trade'.
[702] *Amalgamated Zinc (de Bavay's) Ltd v FCT* (1935) 54 CLR 295.
[703] *H Rubber Estates Bhd v DGIR* [1979] 1 MLJ 115 (Federal Court).
[704] IFRS Foundation, *MFRS 101 Presentation of Financial Statements,* paras 97-98*;* IFRS Foundation, *MFRS 5 Non-Current Assets Held for Sale and Discontinued Operations*, para 33A.

financial effects of the discontinuation.[705] A discontinued operation in this standard refers to a component of an entity which is a major line of business or geographical area that has been disposed of or classified as 'held for sale'. Profit or loss arising from the discontinued operations will be transferred to the company's income statement and shown on the face of this statement.

In a famous Malaysian case, *Ampat Tin Dredging Ltd v DGIR*, a mining company that was wound up because of exhaustion of a tin reserve paid retrenchment benefits to its employees, and sought deductions for those payments.[706] These deductions were not permitted as they did not pass the section 33(1) test allowing deduction for expenses 'incurred in the production of gross income'. According to Mohd Azmi J, when assessing whether retrenchment benefits are deductible, it is essential to determine the precise nature and purpose of the payment made. If the payment was made for redundancy, necessary to save the business from extinction, then it would be allowable. But in the case of a closure of a business, the payment is not related to the production of future income, and hence is not deductible under the judicial interpretation of the nexus requirement in the legislation. This is supported by another case, *DGIR v Kulim Rubber Plantation Ltd*.[707] The company wanted to reduce its rubber plantation and replace it with oil palms in order to boost profits. By doing so, the company was bound by contract to pay its estate agents compensation for loss of remuneration. In this case, the compensation paid was regarded as 'wholly and exclusively incurred in the production of gross income' because the payment arose in the attempt to increase profitability.

The issue of accounting for retrenchment benefits (or termination benefits, as used in accounting standards) is dealt by MFRS 119 *Employee Benefits*. The standard requires that retrenchment benefit to be recognised as a liability and expense at the earlier of the date when the business can no longer withdraw the offer of those benefits, or when restructuring costs, which include retrenchment benefits, are recognised.[708] Due to the different treatment between accounting and taxation, denial of deduction of post-cessation expenditure is regarded as a negative tax expenditure.

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[705] IFRS Foundation, *MFRS 5 Non-Current Assets Held for Sale and Discontinued Operations*, para 30.
[706] *Ampat Tin Dredging Ltd v DGIR* [1982] 2 MLJ 46 (High Court of Malaya).
[707] *DGIR v Kulim Rubber Plantation Ltd* [1981] 1 MLJ 214 (Federal Court).
[708] IFRS Foundation, *MFRS 119 Employee Benefits,* para 165.

Compared to accounting principles, the courts have been excessively rigid in the tax treatment of post-cessation expenses. While accounting principles allow deduction for expenses incurred upon cessation of business without question, the same expenditure is not deductible for tax purposes because it is not related to income producing activities. Indeed, some of the non-allowable expenses are not expenses incurred on cessation of the business but rather are expenditures incurred in relation to income in previous years. As tax law does not recognise the matching concept employed by the accounting approach, this expenditure would be deductible in later years, at which time the company may no longer exist.

In Malaysia, the tax treatment for post-cessation expenditure is the result of the decision in *Ampat Tin Dredging Ltd v DGIR.*[709] When reaching its decision in this case, the learned High Court followed a UK Court of Appeal case, *Godden v A Wilson's Stores (Holdings) Ltd.*[710] In this case, the High Court held that money paid to employees upon cessation of a business was not deductible because it was not incurred in the production of gross income, but rather to cease business. However, subsequently in *CIR (Hong Kong) v Cosmotron Manufacturing Co Ltd*, a Hong Kong case, the Privy Council disapproved of the *Godden* decision and held that the payment in question was an allowable deduction.[711] In this case, the Privy Council decided that severance pay on cessation of business is incurred in the production of profits. The payment is part of the contract of employment, and must be incurred to employ the worker. The expenses were incurred when the worker was employed and only crystallise when the employment is terminated. Although the Malaysian courts are no longer bound by the decisions of the Privy Council, the arguments in *Cosmotron* should not be disregarded.[712]

[709] *Ampat Tin Dredging Ltd v DGIR* [1982] 2 MLJ 46 (High Court of Malaya).
[710] *Godden v A Wilson's Stores (Holdings) Ltd* (1962) 40 TC 161.
[711] *CIR (Hong Kong) v Cosmotron Manufacturing Co Ltd* (1997) BTC 465.
[712] Anand Raj, 'The End of Ampat Tin Is in Sight' (2003) 9(6) *Asia-Pacific Tax Bulletin* 188, 190.

In Australia, court decisions subsequent to the *Amalgamated Zinc*[713] case have retreated from the strict nexus required in that case and appear to have shifted from the 'continuing business test' applied in *Amalgamated Zinc* towards an 'occasion test',[714] that is, where the expenditure is linked to the activity that caused it to arise, although they have not explicitly overruled the reasoning in *Amalgamated Zinc*.[715] The period of payment is not necessarily required to be the same as the period for which the taxable income was derived.[716] This means that a post-cessation expenditure is deductible if the activity that led to its occurrence took place before the cessation.

From a tax expenditure analysis perspective, this tax treatment provides a disincentive to companies to pay termination benefits. But there is no reasonable justification for this. It is based on no valid reason which requires it to be pursued, but rather a court's interpretation of tax legislation (which, based on the above argument, has been misinterpreted). In fact, the Malaysian government, through the Employment (Termination and Lay-Off Benefits) Regulations 1980, has made termination benefits a statutory payment. Thus, there are two conflicting laws involved. While the payment is compulsory, tax rules deter businesses from making this payment by not treating it as a tax deduction. It is therefore highly recommended that, to address this paradox, the tax legislation be amended and the negative tax expenditure removed.

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[713] *Amalgamated Zinc (de Bavay's) Ltd v FCT* (1935) 54 CLR 295. In this case, the company was required to make compulsory payment to an employee compensation fund even after the company discontinued its operation. The company was not allowed to deduct the payment made to the fund after its operation ceased, because it was not incurred to produce the assessable income (after its operation ceased, the company's income was mainly from investments).

[714] The concept was first introduced in *AGC (Advances) Ltd v FCT* (1975) 132 CLR 175.

[715] Andrew Maples, 'The Tax Treatment of Post-Cessation Expenses and Losses in Australia' (2002) 31(3) *Australian Tax Review* 139, 159–160.

[716] Andrew Halkyard, 'Deductions: All is Not Lost', *Hong Kong Lawyer* (December 1996) 24, 24.

6.3.6 Denial of a Deduction for Compliance Expenditure

Type	Deduction not allowed
Brief Description	Compliance expenditure, which includes tax filing and corporate meeting expenses, is not deductible.
Reason(s)	Income tax is appropriation of profits and not incurred in the production of income.[717] Other compliance expenses are not related to income producing activities.
Effective Year	- (Inherited from UK concepts)
Expiry Year	-
Source(s)	• IRBM Public Ruling No 6/2006 *Tax Treatment for Legal and Professional Expenses*
Additional Information	-

Several business expenses that must be incurred to comply with the law have been ruled not deductible on the basis that they do not fulfil the requirement of ITA 1967 section 33(1), that is, they are not connected with income producing activities. Apart from the tax law, companies must comply with other legislation and regulations such as the *Companies Act 1965*, Bursa Malaysia Listing Requirements (for listed companies), Companies Commission Malaysia (for company registration) and the *Banking and Financial Institutions Act 1989* (for banking industry). Tax preparation, account preparation and corporate filing and meeting expenses are not deductible despite the fact that they are compulsory,[718] in respect of which failure to comply would expose companies to imposition of a penalty.

Payment of income tax is not deductible in the calculation of taxable income, on the basis that tax is not related to income earning activities. As such, all expenses related to tax, including filing of tax returns, tax disputes and litigation, and tax penalties are not deductible.[719] In general, because calculation of tax is based on profits, the tax is regarded as an appropriation of profits, and not an ordinary expense. In contrast, taxation and other tax-related expenses are normal business expenses in accounting,

[717] CCH, *Malaysian Tax Reporter*, above n 56, ¶12-810.
[718] IRBM, *Public Ruling No 6/2006 Tax Treatment of Legal and Professional Expenses*, paras 6.3-6.4.
[719] IRBM, *Public Ruling No 6/2006 Tax Treatment of Legal and Professional Expenses*, para 6.4.

although it is common practice to show tax expense for the year as a separate item in the income statement, deducted from profit before tax.

It is acceptable for payment of taxation to be non-deductible, because tax can only be calculated after chargeable income is determined, which means all deductible expenses have been accounted for. However, non-deductibility of tax-related expenditure is a negative tax expenditure. The cost of preparing and filing a tax return, such as the cost incurred in obtaining the advice of a tax consultant, is a non-avoidable expenditure and should be treated as normal business expense. In fact, a business that fails to submit a tax return or submits an incorrect return would be subject to a penalty imposed by the IRBM. This is a bizarre treatment. Businesses are required to comply with the rule but at the same time they are penalised for complying with tax law (by not allowing the cost to be deductible). From another viewpoint, the effect of the rule is that businesses are encouraged to employ an internal tax consultant (where salary is deductible) rather than to outsource provision of the advice to a tax consulting firm.[720] In reality, many businesses prefer to outsource the tax work because it is more cost effective since tax preparation is by its nature seasonal work. Moreover, there is no reason for the government to maintain this position when at the same time it offers various incentives to support the growth of services sector.

Similar peculiarity exists in the tax treatment of the cost of tax disputes and litigation. If denying deduction is analogous to discouragement, this means taxpayers are discouraged from contesting the IRBM's opinion. This situation should not be allowed to continue when the IRBM could misinterpret the law too, especially in those cases where the court decisions ultimately were in favour of the taxpayer. Even if taxpayers are successful in appealing the IRBM's decision, they will have lost in a financial sense because of their inability to recover their litigation expenses. If the amount in dispute is small, taxpayers would rationally just accept the IRBM's opinion, as the cost to bring the case to court would be higher than the benefit that they will obtain even if they are successful.

[720] CTIM, *Memorandum on 2011 Budget Proposals* (3 June 2010), para B-3 <http://www.ctim.org.my/cms/file/news/44/00534_CTIM%202011%20Budget%20Memorandum%20%28030610%29%28F%29.pdf>.

Likewise, companies are required by section 143 of the *Companies Act 1965* to hold a meeting with their shareholders at least once a year. Such meetings attract numerous costs, for instance room hire and printing of the annual report to be distributed to shareholders during the meeting. These costs, too, are non-deductible because they fail to have a link with income-producing activities. Account preparation fees are also regarded as non-income related. Nevertheless, realising the importance of auditing of accounts, in Malaysia the government has issued a tax rule to allow such audit expenditure to be deductible.[721] Unfortunately, other compliance costs mentioned before, such as expenses incurred to hold annual shareholders meeting, are disallowed.

Tax and accounting-related expenses, as well as annual corporate filing expenses, are deductible in developed countries such as the UK[722] and Canada.[723] They are recognised as business expenses. It is strongly suggested that this peculiarity be addressed as soon as possible as it could make Malaysia a disfavoured country for investment.

6.4 TAX REVENUE PROTECTION

In some cases, the government has introduced negative tax expenditures not to penalise or discriminate certain activities, but to prevent loss of tax revenue. There are two reasons for this. First, when it is difficult or impractical to tax the recipients on benefits they receive as income, a negative tax expenditure may be imposed on the providers as a surrogate tax. By doing so, the recipients are not required to pay tax on income they receive, but businesses are not allowed to deduct the amount spent when calculating taxable income. In other words, the provider is the proxy to pay tax on behalf of the

[721] Income Tax (Deduction for Audit Expenditure) Rules 2006.

[722] HM Revenue and Customs, *BIM46450 - Specific Deductions: Professional Fees: Taxation Account & Negotiations* <http://www.hmrc.gov.uk/manuals/bimmanual/BIM46450.htm>; HM Revenue and Customs, *BIM42510 - Specific Deductions: Administration: Company Share Costs etc* <http://www.hmrc.gov.uk/manuals/bimmanual/bim42510.htm>.

[723] Canada Revenue Agency, *Income Tax Interpretation Bulletin: IT99R5 (Consolidated) Legal and Accounting Fees* (6 September 2002) <http://www.cra-arc.gc.ca/E/pub/tp/it99r5-consolid/it99r5-consolid-e.html>.

recipient. A negative tax expenditure could also arise to prevent abuse of tax deduction facilities.

6.4.1 Restricted Deduction for Entertainment Expenses

Type	Deduction not allowed
Brief Description	Entertainment expenses that are incurred for business purposes are only 50% deductible, except for those allowed by the Act.
Reason(s)	To control unnecessary lavish entertainment expenses and to widen tax base.[724] As a surrogate tax since it is impossible to tax the recipient.
Effective Year	1988
Expiry Year	-
Source(s)	• ITA 1967 s 39(1)(l) • IRBM Public Ruling No 3/2008 Entertainment Expense
Additional Information	- 'Entertainment' includes the provision of food, drink, recreation or hospitality of any kind, or the provision of accommodation or travel in connection with or for the purpose of facilitating those provisions. These provisions must be incurred for business purposes.[725] - Entertainment expenses that can be fully deductible are:[726] o Entertainment for employees (except if the entertainment is incidental to others) o When entertainment is part of normal business activities o Promotional gifts at foreign trade fairs/exhibitions for promotion of exports o Promotional product samples o Entertainment for cultural or sporting events open to the public o Promotional gifts in Malaysia with business advertisement or logo o Entertainment incurred wholly related to sales o Employee leave passage to facilitate a yearly event within Malaysia, only once a year.[727]

[724] *Malaysian Budget Speech 1989*, in Malaysia, *Parliamentary Debates*, House of Representatives, 21 October 1988, 6040-6041, 6078 [Appendix II] (Daim Zainuddin); Malaysia, *Parliamentary Debates*, Senate, 5 December 1988, 39-40 (Daim Zainuddin).
[725] ITA 1967, s 18.
[726] ITA 1967, s 39(1)(l).
[727] See 'Employee Leave Passage' in Section 6.4.3.

Accounting principles allow all entertainment expenses, under whatever names, to be deducted in the income statement, as long as the expense is incurred for business purposes and is not personal expenditure. Even though no detailed disclosure is required, auditors are expected to find any personal expenses or misappropriation of company resources during the audit. Thus, all expenses in the audited income statement are assumed to be legitimate business expenses. Nevertheless, accounting is not concerned with whether the expenditure was spent lavishly or unnecessarily, as long as it was spent for business purposes.

Under tax principles, entertainment expenses are also treated as business expenses for tax purposes. Before 1989, all entertainment expenses that were related to business were deductible. Despite being an area subject to detailed scrutiny by the IRBM, there are still many abuse cases on such expenditure, where it was used to entertain family members and friends, or was spent on luxury entertainment.[728] As a result, the legislation was amended to provide for stricter control over deduction for entertainment expenses. The government also claims that the amendment is part of corporate income tax reform to widen the tax base.[729] At first, all entertainment expenses were non-deductible, unless specifically allowed by the legislation. Later in 1988, the rule was relaxed, so that entertainment expenses that are wholly and exclusively incurred in the production of gross income are now subject to a 50 per cent deduction rule. Full deduction is available only for expenses that fall within the exception provisions listed in section 39(1)(l) of ITA 1967. Therefore, the restricted tax deduction for entertainment expenses is a negative tax expenditure.

Although the definition of 'entertainment' is provided in the legislation, it is still a problem to differentiate non-deductible entertainment expenses from normal marketing and selling expenses. The word 'hospitality' used in the definition is ambiguous. Thus, many cases have been brought to court to decide whether an expense falls within the definition of entertainment. Interestingly, most of the judicial decisions have been in

[728] Veerinderjeet Singh and Teoh Boon Kee (eds), *Malaysia Master Tax Guide 2009* (CCH Asia, 26th ed, 2009) 339.

[729] *Malaysian Budget Speech 1989*, in Malaysia, *Parliamentary Debates*, House of Representatives, 21 October 1988, 6040-6041, 6078 [Appendix II] (Daim Zainuddin); Malaysia, *Parliamentary Debates*, Senate, 5 December 1988, 39-40 (Daim Zainuddin).

favour of the taxpayer.[730] This indicates that the IRBM has adopted an unduly rigid definition as compared to the approach of the courts.

Lavish entertainment expenses should not be a problem to the revenue authority if the benefits are assessable to the recipients. Unfortunately, it is administratively impractical to assess tax on the recipients. Therefore, the restriction on deduction of entertainment expenses is actually a surrogate tax, as a proxy to ensure the benefits are taxable. Allowing deduction for entertainment expenses is akin to a tax concession to the recipients of these expenses, which may not be the needy group that should receive government assistance. For this reason, this negative expenditure is acceptable and requires no amendment. In addition, entertainment expenses could also be a form of bribery in disguise.[731] If it is really bribery, denying a deduction is the correct tax policy. Currently, Malaysian tax law allows bribery to be a tax deduction; however, as proposed in Section 6.5.2, it is desirable that payment of bribery is made not deductible.

[730] *Aspac Lubricants (Malaysia) Sdn Bhd v KPHDN* [2007] MSTC 4,271 (Court of Appeal); *Office Park Development Sdn Bhd v KPHDN* [2011] MSTC ¶30-023 (High Court); *MHL Sdn Bhd v KPHDN* [2011] MSTC ¶10-014 (SCIT); *ME Holding Sdn Bhd v KPHDN* [2011] MSTC ¶10-013 (SCIT); *KPHDN v Servier Malaysia Sdn Bhd* [2012] MSTC ¶30-038 (High Court); *NV Alliance Sdn Bhd v KPHDN* [2012] MSTC ¶30-047 (Court of Appeal).

[731] ADB/OECD Anti-Corruption Initiative for Asia and the Pacific, *Anti-Corruption Policies in Asia and the Pacific: Progress in Legal and Institutional Reform in 25 Countries* (Asian Development Bank and OECD, 2006) 27-28.

6.4.2 Restricted Deduction for Non-Commercial Motor Vehicle

Type	Deduction not allowed
Brief Description	Rental and capital allowance for non-commercial motor vehicle is restricted to: o MYR 50,000 (AUD 16,700), or o MYR 100,000 (AUD 33,000), if the motor vehicle is new and its cost does not exceed MYR 150,000 (AUD 50,000).
Reason(s)	To avoid abuse of the system by purchasing a car larger and more expensive than required.[732]
Effective Year	1985, with amendments later
Expiry Year	-
Source(s)	• ITA 1967, s 39(1)(k) • ITA 1967, sch 3, para 2(2)
Additional Information	Non-commercial motor vehicle refers to a motor vehicle that is not licensed for commercial transportation of goods and passengers.

Most businesses need to use fixed assets in their day-to-day operations. It is uncommon for the fixed assets to be acquired in cash terms, unless the cost is insignificant. Instead, they are commonly financed through leasing, where payments are made over a period of time. There are two types of lease that may be used; an operating lease and a finance lease. Under an operating lease, the risks and rewards associated with the asset remain with the lessor,[733] and the lease rental payment made by the lessee is treated as a normal business expense in the income statement.[734] In the case of a finance lease, the asset is considered as owned by the lessee and shown in the balance sheet. The unpaid amount is shown as a liability, and the lease payment made is separated between the principal amount that reduces liability, and the interest amount that is written off in the income statement. In addition, the lessee also provides for depreciation of the asset.[735]

Tax legislation provides a treatment similar to that of accounting for each type of lease. Lease rental payments for an operating lease are allowed as a deduction. In the case of a finance lease, a capital allowance is available for qualifying assets. However, the deductible amount for both operating lease (rental) and finance lease (capital

[732] CCH, *Malaysian Tax Reporter,* above n 56, ¶31-910.
[733] IFRS Foundation, *MFRS 117 Leases*, para 8.
[734] IFRS Foundation, *MFRS 117 Leases*, para 33.
[735] IFRS Foundation, *MFRS 117 Leases*, paras 20-30.

allowance) is restricted for motor vehicles not licensed for commercial transportation of goods and passengers. A deduction is allowed only up to the amount of MYR 50,000 (AUD 16,700). A higher deduction, up to MYR 100,000 (AUD 33,000), is available for a motor vehicle that is new, and the cost of which does not exceed MYR 150,000 (AUD 50,000).

Since the tax treatment in this case differs from the accounting treatment, this is a negative tax expenditure. The restriction is introduced to prevent businesses from taking advantage of the deduction by purchasing unnecessary luxury cars. The higher the cost of the car, the greater the deduction which could otherwise be claimed; hence it causes a greater loss of tax revenue. However, a more justifiable reason is that the restriction acts as a surrogate tax, since the current benefits-in-kind rule fails to fully capture the personal usage of the car to be taxed on employees. Under the benefits-in-kind rule,[736] the car benefit received by an employee is assessed on the employee's private usage based only on the cost of the car. Other operating expenses such as repairs and maintenance, insurance and road tax are not taxable on employees. The rule determines taxable benefit based on 80 per cent of the cost of the car spread over eight years of expected useful life of the car. In other words, the taxable car benefit is the private usage of 10 per cent of the cost of the car. Alternatively, employees can choose to be taxed based on the prescribed value method, where a concessional car value lower than that calculated using the formula method is available, determined based on the following table:[737]

[736] IRBM, Public Ruling No 2/2004 *Benefits-in-Kind*, para 6.1.
[737] IRBM, Public Ruling No 2/2004 *Benefits-in-Kind*, Appendix 2.

Cost of New Car (MYR)	Annual Prescribed Benefit of Car (MYR)
Up to 50,000	1,200
50,001 – 75,000	2,400
75,001 – 100,000	3,600
100,001 – 150,000	5,000
150,001 – 200,000	7,000
200,001 – 250,000	9,000
250,001 – 350,000	15,000
350,001 – 500,000	21,250
500,001 and above	25,000

*Note: MYR 1 = approximately AUD 0.34 (22 Aug 2013)

The above table shows that the concessional value is less than half the value based on the formula method, except in a small number of cases (where it is more than half the value based on the formula method, but still lower). Of course employees will choose the prescribed value method. If the real assessable car benefit received by employees is measured using the value under the formula method (that is, 10 per cent of the value of the car), the concessional value would result in more than half of the real benefit being not taxable. Thus, the restriction on the employer's deduction is seen as a way to tax the remaining employee benefit.

Perhaps the actual value of the car benefit is too high where the government provides a concessional value to the employee, especially when the employee receives a luxury car. The restricted deduction could be argued to be a feasible way to protect government revenue by indirectly taxing the employer (through denial of a deduction for the full cost of the benefit). An alternative that might be considered is adoption of an explicit fringe benefits tax such as that used in Australia and New Zealand which directly taxes employers on the value of non-cash employment benefits that are not assessed to the employees.

6.4.3 Denial of a Deduction for Employee Leave Passage

Type	Deduction not allowed
Brief Description	Expenses incurred on employee leave passage are not deductible, except if incurred to facilitate a yearly event within Malaysia which involves the employer, employee and immediate family members of the employee.
Reason(s)	To widen the tax base in order to boost government tax revenue.[738]
Effective Year	1988
Expiry Year	-
Source(s)	• ITA 1967, ss 39(1)(m), 39(1)(l)(viii) • IRBM Public Ruling No 1/2003 *Tax Treatment on Leave Passage* • Addendum to IRBM Public Ruling No 1/2003 *Tax Treatment on Leave Passage*
Additional Information	- 'Leave passage' refers to travelling during a period of absence or vacation from duty or employment.[739] - The non-deductible cost here relates to the travelling fares. Costs of food and accommodation are regarded as entertainment expenses and are deductible, but only for the amount incurred for the employee. Amounts incurred for family members are not deductible.

Leave passage is one of the benefits given by an employer to its employees. Accounting treats it like other employee remuneration, as an expense in the income statement. Tax principles recognise employee leave passage as a business expense wholly and exclusively incurred in the production of gross income; however, it has been disallowed by section 39(1)(m) of the ITA 1967 as part of the government's effort to widen the tax base. Hence, it is a negative tax expenditure for business.

It should be noted that this leave passage is tax free in the hands of the employee.[740] Before 2007, this sum was a deductible item for the company and not taxable to the employee. The denial of a deduction has been introduced as a surrogate tax to

[738] Malaysia, *Parliamentary Debates*, Senate, 5 December 1988, 40 (Daim Zainuddin); Chamhuri Siwar and Zulkifly Osman, 'Prestasi Ekonomi 1988 dan Belanjawan 1989' (1988) 18 *Jurnal Ekonomi Malaysia* 107, 116.

[739] IRBM, Public Ruling No 1/2003 *Tax Treatment on Leave Passage*, para 3.7.

[740] ITA 1967, s 13(1)(b)(ii). Under this section, an employee is not taxable in respect of employment benefit received for him or herself and immediate family, in terms of leave passage, including meals and accommodation, for travelling within Malaysia (limited to three times) or overseas (only one time, restricted to MYR 3,000, equivalent to AUD 1,000)

substitute for taxing the benefit to the employee. The government has decided on some basis that it is the business which should pay tax on the benefit, instead of the employee. This may be a more efficient way of collecting the tax. Also, it may be fairer to employees who would find they had no cash to pay the tax on a non-cash benefit.

6.4.4 Denial of a Deduction for Failure to Withhold Tax

Type	Deduction not allowed
Brief Description	Payments made to non-residents are not allowed to be deducted if taxpayer failed to withhold tax.
Reason(s)	To ease tax collection from non-residents.
Effective Year	- (Incorporated in ITA 1967 when enacted)
Expiry Year	-
Source(s)	• ITA 1967, ss 39(1)(f), 39(1)(i), 39(1)(j) • IRBM Public Ruling No 1/2010 *Withholding Tax on Income Under Paragraph 4(f)*
Additional Information	Payments to non-residents that are subject to withholding tax are:[741] a. Contract payments; b. Interest, royalty and payments to public entertainer; c. Payments for services in connection with the use of his property or installation of plant and machinery purchased from him; d. Payments for technical advice, assistance or services; e. Any other payment falling under section 4(f) of ITA 1967.[742]

It is a common practice in many countries to require taxpayers to withhold tax on a payment made to non-residents.[743] This is mainly to assist collection of tax from non-residents. Once non-residents leave a country, it is difficult to trace them, thus withholding tax is seen as an efficient way to collect tax from them.

[741] ITA 1967, ss 107A, 109, 109A, 109B, 109F.

[742] ITA 1967 s 4(f) covers chargeability to tax on any kind of income received apart from specific income mentioned in sections 4(a) – 4(e), which charge to tax income received from business, employment, dividend, interest, discount, rent, royalty, premium, pension, annuity and other periodical payments. Section 4(f) ensures all revenue income is taxable.

[743] Among countries that apply some kind of withholding tax requirements are Australia, New Zealand, the US and India.

The responsibility to withhold tax must be taken seriously as there is a penalty imposed if a taxpayer fails to do so. In addition, the payment made to non-residents, which normally is deductible as a business expense incurred in the production of income, would not be allowed for deduction as a punishment for failure to withhold tax.[744] The deduction will later be allowed if the taxpayer subsequently pays the tax withheld together with any penalty imposed. Accounting standards would allow payments made to non-residents as a deduction regardless of whether the withholding tax requirements have been complied with.

Since the tax treatment for payment to non-residents deviates from the benchmark using accounting practice, this is a negative tax expenditure. Nevertheless, because this provision is part of administrative measures for the purpose of compelling compliance with tax administration requirements, it does have a legitimate goal. The denial of a deduction is an additional punishment on top of the penalty imposed for failure to withhold tax. Unlike the penalty, this punishment is 'refundable' once the tax withheld, together with the penalty, is submitted to the IRBM. This tax measure provides strong compulsion to ensure compliance among taxpayers. The fact that the measure is adopted by many countries suggests that this is an effective way to achieve the intended goal. Therefore, this negative tax expenditure should remain in Malaysia's tax system.

[744] ITA 1967, ss 39(1)(f), 39(1)(i) and 39(1)(j); IRBM, Public Ruling No 1/2010 *Withholding Tax on Income Under Paragraph 4(f).*

6.4.5 Restricted Deduction for Employer's Contribution to Approved Pension or Provident Fund

Type	Deduction not allowed
Brief Description	Employer's contribution to approved pension or provident fund is deductible only up to 19% of employee's remuneration. Excess contribution is not deductible.
Reason(s)	To cap tax benefit received by employees, since employees are not taxed on employer's contribution.
Effective Year	- (Incorporated in ITA 1967 when enacted)
Expiry Year	-
Source(s)	• ITA 1967, s 34(4)(a)
Additional Information	- 'Approved pension or provident fund' means the Employees Provident Fund (EPF), private retirement scheme or any pension or provident fund approved by the DGIR. - 'Private retirement scheme' means a retirement scheme approved by the Securities Commission of Malaysia in accordance with the *Capital Markets and Services Act 2007*.

In Malaysia, private companies are required to make a contribution to the EPF, a social security institution and government statutory body that provides compulsory retirement saving for employees. Contribution to the EPF is mandatory for all private sector and non-pensionable public sector employees.[745] The minimum statutory contribution by an employer to the EPF is 13 per cent for employees that earn wages of MYR 5,000 (AUD 1,700) or less,[746] and 12 per cent for employees with wages more than MYR 5,000 (AUD 1,700).[747]

Although an employer's contribution to the EPF, private retirement scheme and other approved pension and provident fund is tax deductible, the deduction is restricted to 19 per cent of the employee's remuneration. If the amount contributed by the employer is more than that the restricted figure, the excess is a permanent loss to the company. In

[745] Employees Provident Fund, *Overview of the EPF* (3 Sept 2012) <http://www.kwsp.gov.my/portal/en/about-epf/overview-of-the-epf>.

[746] The term 'wages' is defined by section 2 of *Employees Provident Fund Act 1991* as all remuneration in money, including bonus, commission and allowance, but does not include a service charge, gratuity, overtime payment, retirement or retrenchment benefit and travelling allowance.

[747] *Employees Provident Fund Act 1991*, Part A Third Schedule.

accounting, all benefits paid to employees are normal expenses and can be deducted in arriving at net profit. Since the tax treatment deviates from the accounting benchmark, this is a negative tax expenditure.

When analysing the restriction of deduction using the tax expenditure framework, this could be argued to be a rational policy. The employer's contribution, together with the subsequent dividend earned, is tax-free in the hands of employees. Therefore, the restriction is to limit the tax-free benefit received by employees. The maximum deductible contribution is set higher than the minimum statutory contribution. Thus the non-allowable contribution is only the voluntary part and would not affect all companies. Alternatively, the government could tax employees when they withdraw money from the fund. However, since money from the fund is usually withdrawn after retirement when employees have no other sources of income, most probably it would still be exempt from tax because the amount is lower than the tax-free threshold. Hence, current tax policy is the most feasible for the moment and should be maintained.

6.5 DISCOURAGING PARTICULAR EXPENDITURES

This section presents negative tax expenditures introduced as a discouragement or prevention from certain undesirable acts. Most relate to revenue expenditure incurred in the production of gross income, but which have been specifically prohibited.

6.5.1 Denial of a Deduction for Fines, Penalties and Other Payments Related to Unlawful Activities

Type	Deduction not allowed
Brief Description	Payment for fines and penalties is normally not deductible. Cost of legal proceedings in connection with criminal and unlawful acts are not deductible.
Reason(s)	Most courts have denied deduction on the basis that it is not related to income earning activities. However, many believe that allowing deduction could frustrate the objective of another law.
Effective Year	- (Inherited from UK concepts)
Expiry Year	-
Source(s)	• *CIR v EC Warnes & Co Ltd* • *CIR v Alexander von Glehn & Co Ltd* • *Mayne Nickless Limited v FCT* • *65302 British Columbia Ltd v The Queen* • *Day & Ross Ltd v The Queen* • IRBM Public Ruling No 6/2006 *Tax Treatment for Legal and Professional Expenses*
Additional Information	-

Accounting treatment allows any fines, penalties and other expenses related to illegal activities to be written off as long as they are incurred for business purposes. An expense is recognised in the income statement when a liability is incurred without the recognition of an asset.[748] Fines and penalties give rise to a liability, as the business has a present obligation to pay. Therefore, as long as fines and penalties incurred are related to the business, they should be expensed in the income statement.

On the other hand, most fines and penalties incurred for violations of the law will not be allowable for tax purposes. There are two rationales to justify this approach. The first, which was developed in early cases regarding deductibility of fines, is that the payment is not related to income-producing activities. For a payment to be deductible, it must be made for the purpose of earning profits. Being connected to trade, or arising out of trading activities, is not sufficient.[749] It was argued by revenue authorities that penalties are incurred because the person who conducts the trade has committed an infraction of

[748] IFRS Foundation, *The Conceptual Framework for Financial Reporting*, above n 239, para 4.53.
[749] *CIR v EC Warnes & Co Ltd* (1919) 12 TC 227; *CIR v Alexander von Glehn & Co Ltd* (1920) 12 TC 232.

the law and are not related to the earning of profits. This rationale was often used by courts as the basis for denying deductions for these expenses.[750] In fact, this rationale remains the main basis to the present day for judicial decisions denying deductions for fines. However, some argue that this is an unconvincing and flawed rationale for the approach. Critics of the decisions concede the fines are incurred as a result of breaches of law but point out that the law was breached in pursuit of profits and the infraction was thus part of an income-earning exercise.[751]

The more plausible rationale is that of public policy doctrine. Proponents of this doctrine contend that the position taken in one law should not frustrate the objective of another law.[752] By allowing fines to be tax deductible, the actual amount paid is reduced. This may reduce the deterrent effect of the fines, and undermine the effectiveness of the law.[753] However, in many countries, the courts have never approved the public policy argument. In Canada, it was mentioned only as a passing reference by the courts and delivered as a supporting argument.[754] The profit-earning purpose test remains the main consideration. The Australian courts have explicitly denied a deduction for fines on the ground of public policy.[755]

Subsequently in Canada, the significance of public policy was removed from the court's consideration and the court has confirmed that, to determine the deductibility of an expense, the court should consider the general test set out in the tax legislation (that is, the profit-earning purpose test), not a second test based on general public policy.[756] This precedent concluded that considerations based on protecting the integrity of public policy are within the scope of parliament's power, not that of the judiciary.

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[750] See, for example, *Luscoe Products Ltd v MNR* (1956) 57 DTC 32; *Canadian Motor Sales Corporation Ltd v MNR* (1977) 77 DTC 30.

[751] Richard Krever, 'The Deductibility of Fines: Considerations from Law and Policy Perspectives' (1984) 13(1) *Australian Tax Review* 168, 206.

[752] Neil Brooks, 'The Principles Underlying the Deduction of Business Expenses', in Brian G Hansen, Vern Krishna and James A Rendall (eds), *Canadian Taxation* (Richard De Boo Limited, Toronto, 1981) 189, 242; Tamara Sibley, 'Breaking the Law and "Writing it Off": Should Fines and Penalties be Deductible Under the Income Tax Act?' (2002) 65 *Saskatchewan Law Review* 217, 233.

[753] Brooks, 'The Principles Underlying the Deduction of Business Expenses', above n 752, 243.

[754] *Day & Ross Ltd v The Queen* (1976) 76 DTC 6433; *TNT Canada Inc v Canada* (1988) 88 DTC 6334.

[755] *Mayne Nickless Limited v FCT* (1984) 84 ATC 4458; *Madad Pty Limited v FCT* (1984) 84 ATC 4739.

[756] *65302 British Columbia Ltd v The Queen* (1999) 99 DTC 5799.

There are few recent cases dealing with the deductibility of fines and penalties, as the position that fines and penalties are not deductible for tax purposes is widely regarded as settled law. Not a single case concerning this issue can be found in the Malaysian context. Some recent cases have dealt with this issue in the UK, but these also have held that fines are not deductible on the basis that it was not part of the cost of carrying on business.[757]

However, in practice, some fines and penalties which arise through an employee's negligence during the normal performance of their duties, for example traffic fines imposed on a transport company's driver, are deductible for tax purposes.[758] This practice is parallel to the finding from another Canadian case which allowed the deduction of fines imposed on an overweight truck because the fines were incurred as a result of the daily operation of a trucking business.[759]

Given the scarcity of cases dealing with the deductibility of fines and penalties in Malaysia, it is difficult to determine which position is applied in Malaysia. Based on the IRBM's practice, the protection of public policy is still considered when deciding whether fines and penalties should be allowable as a deduction.[760] The current practice in Malaysia, where payments made on fines and penalties are not allowable for tax purposes, suggests a negative tax expenditure, because it deviates from the neutral benchmark of measuring business profits.

Nevertheless, the idea of 'protecting public policy' is not mentioned in Malaysia's tax legislation, which suggests that it should not be considered when calculating taxable profits. Thus, the judiciary will need to construe this consideration as a matter of legislative intention. Some commentators have suggested that this objective is sufficiently important that it should be enacted through legislation. In this way, judicial decisions will be far more justifiable. However, the law should be enacted with careful

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[757] *McKnight (HM Inspector of Taxes) v Sheppard; Sheppard v McKnight (HM Inspector of Taxes)* (1996) BTC 355.
[758] Singh, *Veerinder on Taxation,* vol 2, above n 540, 741.
[759] *Day & Ross Ltd v The Queen* (1976) 76 DTC 6433.
[760] CCH, *Malaysia Master Tax Guide*, above n 490, ¶1101.

examination of whether the goal to protect public policy can really be achieved through this law.[761]

Similarly, tax legislation is silent regarding deductibility of payments made in connection with illegal activities. Although the IRBM is of the opinion that expenses incurred on illegal activities should not be allowed as a deduction due to their illegal status, that opinion was rejected by the court.[762] Besides, because income from illegal activities is subject to tax,[763] expenses for illegal activities should be deductible. As such, unless the legislation explicitly disallows an expense connected to illegal activities, it should be assumed to be deductible as long as it is incurred in the production of gross income. But in its public ruling, the IRBM has included 'the cost of defending criminal prosecution or in connection with unlawful acts in the operation of a business' in the examples on non-allowable legal expenses.[764] Denying deductibility of these expenses is a negative tax expenditure. However, in general, it is believed that payments related to illegal activities are regarded as deductible as long as they are documented; hence no negative tax expenditure arises.

[761] Krever, 'The Deductibility of Fines', above n 751, 205.
[762] *DGIR v LTS* [1950-1985] MSTC 374 (High Court of Malaya).
[763] *Partridge v Mallandaine* (1886) 2 TC 179.
[764] IRBM, *Public Ruling No 6/2006 Tax Treatment of Legal and Professional Expenses*, para 6.6.

6.5.2 Denial of a Deduction for Illegal Payments

Type	Deduction not allowed
Brief Description	Payment made for the use of licence or permit for timber extraction other than to a State Government or other approved government authority is not deductible. Donation to political party, which resembles bribery to the ruling government, is not deductible. However, tax legislation is silent regarding other payments.
Reason(s)	To stop illegal activities. In the case of the timber extraction licence, the rule is to prevent the person who obtained the licence from selling it to a third party.[765]
Effective Year	- (Incorporated in ITA 1967 when enacted)
Expiry Year	-
Source(s)	• ITA 1967, s 39(1)(g) for illegal payments made for the use of licence or permit for timber extraction. Other illegal payments are not covered by ITA 1967.
Additional Information	-

Illegal payments and expenses related to illegal activities are two different items. For example, payment of bribery is illegal, but payment of legal fees relating to defence against a bribery prosecution is a legitimate expense that arises out of a potentially illegal act. Accounting principles have no concern over the legal status of an expense and would allow these expenses for deduction, as long as they are incurred for a business purpose. It is possible, however, for business not to explicitly record payment of bribery in its accounting books but would use other terms, such as provision of technical services,[766] since accounting records can be used as evidence in a court prosecution.

In general, illegal payments are tax deductible in Malaysia, unless there is a specific clause in the legislation that denies deduction. Payment made for the use of licence or permit for timber extraction other than to a state government or other government authority has been explicitly disallowed for deduction under section 39(1)(g) of the ITA

[765] *ML & 2 Ors v KPHDN* [2000] MSTC 3804 (Court of Appeal).

[766] Ernst and Young, *UK Bribery Digest* (E&Y Fraud Investigation and Dispute Services, January 2012) <http://www.ey.com/Publication/vwLUAssets/UK_Bribery_Digest_edition_1_January_2012/$FILE/EY_UK_Bribery_Digest_edition_1_Jan_2012.pdf> 12.

1967 to counteract the illegal practice of selling the rights of timber extraction to a third party.[767] This payment is treated as an ordinary business expense in accounting practice. In principle, it is also a revenue expense for tax purposes,[768] but a deduction has been specifically prohibited. Denying deductibility of a business expense is a negative tax expenditure.

However, this can be argued to be a sensible tax policy to prevent the illegal transfer of timber extraction rights. The timber industry is one of the main contributors to Malaysia's export revenue and Malaysia itself is one of the largest exporters of tropical timber and timber products.[769] Due to the importance of trees to ensure a balanced natural environment, timber extraction must be closely monitored. Only certain designated areas are allowed for logging activities, and the timber extraction process is subject to strict procedures.[770] Timber can only be extracted by those who have been awarded a licence or permit by the government. Unfortunately, some of the timber licensees have abused the privileged rights by selling the timber extraction rights to a third party for easy profits.[771] While the original licensee could be penalised, this tax policy penalises the third party who bought the right. Thus, both parties involved in the illegal agreement are penalised.

Based on the above arguments, it could be contended that denial of deduction for political donations is a good policy to reduce corruption within government. Nevertheless, the tax law should be amended to explicitly deny the deduction. Some political expenses could still be argued to be connected to income earning activities so as to be deductible, such as lobbying for new legislation that can give advantage to the

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[767] One of the terms of the licence is that the extraction right is not transferable.

[768] *ML & 2 Ors v KPHDN* [2000] MSTC 3804 (Court of Appeal).

[769] Ministry of Plantation Industries and Commodities, *National Industry Timber Policy 2009-2020* (2009) 3.

[770] Ministry of Plantation Industries and Commodities, 'Malaysia: Timber Trade Regulations and Licensing System' (Paper presented at the Consultations with Stakeholder Groups Related to the EU Forest Law Enforcement, Governance and Trade Voluntary Partnership Agreements Negotiations, Malaysia, 22 June 2007) <http://loggingoff.info/document/malaysia-timber-trade-regulations-and-licensing-system>.

[771] Anthony Shome and Syahira Hamidon, 'The Contradiction of Entrepreneurship through Affirmative Action: The Case of Malaysia' (2009) 27(1) *Copenhagen Journal of Asian Studies* 28, 52; *ML & 2 Ors v KPHDN* [2000] MSTC 3804 (Court of Appeal).

business.[772] If there are concerns over the undue influence of business taxpayers on the political process, there is a case for prohibiting the payments completely, not just restricting deductions for tax purposes.

Many countries, including Malaysia, treat bribery payments as normal business expenses and thus as deductible. Some claim that it is an unavoidable cost, especially when dealing with certain foreign countries where bribery has been part of the culture in those countries.[773] Regardless of these arguments, bribery is illegal and is an unhealthy practice that could negatively affect the economy. While bribes to local public officers are generally illegal and can lead to prosecution, payment of bribes to public officers of foreign countries is not a crime.[774] The OECD has since the 1990s played an active role in combating bribery. Their effort includes the recommendation that tax authorities among member countries explicitly deny a tax deduction for the payment of bribery.[775] This has been the centre of the OECD's effort, and it has been a success among its members. The campaign has since been expanded to other non-member countries, including Malaysia.[776] However, until now, Malaysia has not undertaken a similar move. It is recommended that Malaysia disallows payment of bribery for tax deduction.

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[772] *Cooper v Rhymney Breweries Ltd* (1965) 42 TC 509.

[773] Sturla Johnson, 'No to Taxfree Backhanders' (2001) 14(3) *For A Change* <http://www.forachange.net/back/issue/article/1707.html>.

[774] OECD, *OECD Bribery Awareness Handbook for Tax Examiners* (OECD Centre for Tax Policy and Administration, 2009) 15.

[775] OECD, *OECD Bribery Awareness Handbook for Tax Examiners*, above n 774, 10.

[776] Malaysian Anti-Corruption Academy, 'Joint MACA/OECD Technical Seminar Promoting the Enforcement of Malaysia's Offense Against Bribing Foreign Public Officials' (2012) 4 *MACA Newsletter* 1, 1.

6.5.3 Denial of a Deduction for Payment to Unapproved Pension, Provident and Other Similar Funds

Type	Deduction not allowed
Brief Description	Only payments made by an employer for employees' benefits to an approved scheme are deductible. Payments to unapproved scheme are not deductible.
Reason(s)	As part of government control to avoid fraud.[777]
Effective Year	- (Incorporated in ITA 1967 when enacted)
Expiry Year	-
Source(s)	• ITA 1967, s 39(1)(d)
Additional Information	'Approved scheme' means the EPF, private retirement scheme or any pension or provident fund, scheme or society approved by the DGIR.

Salary packages offered by employers generally include a contribution by the employer to a pension or provident fund, or private retirement scheme. Although this is clearly a revenue expense and should be treated in a similar way to salary, the tax legislation has disallowed deduction if the contribution is made to an unapproved fund or scheme. By contrast, accounting does not discriminate between funds/schemes. All employees' remuneration, regardless of its form, is an expense. Therefore, this is a negative tax expenditure.

A provident fund or retirement scheme represents employees' savings to be used after they retire. It is important to employees as after retirement they normally would not have any source of income and will need to depend on income from the fund to support their living. Therefore the fund must be closely monitored to ensure that the money is properly managed and that the management of the fund is free from fraud. The single purpose of the fund is to provide for employees' retirement benefits. This negative tax expenditure is to compel companies to register their provident fund as an approved scheme so that it can be observed by the government. Thus, this is a sound tax policy and should be maintained. It is not discrimination against unapproved funds but is

[777] Author's assumption, based on E Philip Davis, 'Investment of Mandatory Funded Pension Schemes', (Working Paper PI-9908, Pensions Institute, Birkbeck College, London, 1999) 32.

simply to ensure that all provident funds are registered for monitoring purposes. The disincentive can be avoided by ensuring the fund is an approved scheme.

6.6 TIMING

Among the main causes of differences between accounting and taxation is the different point of recognition of expenses. Accounting relies on the matching principle, where expenses are matched with revenue earned, and liability is said to arise when the obligation to pay arises. Taxation takes a more conservative approach, where in most cases certainty (regarding the amount payable) is the main consideration.

6.6.1 Deferral of a Deduction for Provisions and Future Expenditure

Type	Deferral of deduction
Brief Description	Deduction for provisions is allowed only when the liability crystallises, not when it is incurred.
Reason(s)	At the point it is incurred, the actual amount payable is uncertain.
Effective Year	- (Inherited from UK concepts)
Expiry Year	-
Source(s)	• *MWM Sdn Bhd v DGIR* • *Exxon Chemical (Malaysia) Sdn Bhd v KPHDN*
Additional Information	-

There are different types of provisions and whether they give rise to negative tax expenditures or not should depend on the accounting and tax treatments of each provision. The divergent treatment of provisions stems from the different criteria used in accounting and tax. Accounting principles require financial statements to be prepared based on matching and prudence concepts in order to provide relevant information to users of financial statements. Consequently, some future expenditure is required to be recognised and expensed in the current period, even though there are uncertainties with regard to its amount or timing. Failure to do so may misrepresent the financial statements and provide false information to users. In contrast, tax legislation

allows deductions only on outgoings and expenses that have been incurred, which means liabilities must arise during the period.

MFRS 137, *Provisions, Contingent Liabilities and Contingent Assets*, defines a provision as a liability of uncertain timing or amount.[778] Given the uncertainties, a prudent approach means that the provision must be calculated and accounted for so that financial statements will include all information necessary for their users to understand the company's financial position and performance.[779] Nevertheless, it is not necessary for all uncertain liabilities to be included in the accounts. A future uncertain liability should be recognised as a provision only when there is a present obligation imposed on the company, which the company will be required to settle using its resources (for example money), and a reliable estimate of the amount of the obligation can be made.[780] Criteria for determining this estimate include past experience, risk assessment and the time value of money.

In addition to the prudence concept, accounts must be prepared based on the matching principle, that is, revenue generated must be matched with expenses incurred to generate the revenue, which is the reason why the expenses need to be deducted in the current period, not later when payment is made. This principle gives rise to a number of provisions. The discussion here focuses on the differences between accounting and tax treatments of provisions for retirement benefits, provisions for leave pay, provisions for warranty claims and future costs of dismantlement, removal and restoration.

The key issue regarding the tax treatment of provisions is the timing of the deduction. The amount is deductible, but not in the same period as practised in accounting. Tax law only allows deductions for certain provisions in circumstances where that liability has arisen during the relevant basis period, for instance provision for directors' fees and bonuses.[781] Provisions that involve future expenses and uncertain amounts will not be

[778] IFRS Foundation, *MFRS 137 Provisions, Contingent Liabilities and Contingent Assets*, para 10.
[779] Lazar and Choo, above n 664, 475.
[780] IFRS Foundation, *MFRS 137 Provisions, Contingent Liabilities and Contingent Assets,* para 14.
[781] CCH, *Malaysian Tax Reporter,* above n 56, ¶10-050.

allowable for tax purposes. In many cases, the expense is deductible only after the liability crystallises, or when the payment is actually made.[782]

Another related issue is the meaning of the word 'incurred'. The ITA 1967 has provided that for an outgoing and expense to be tax deductible, it must be 'incurred'. 'Incurred' does not mean that it must be paid. Any payable expense should also be deductible, as long as there is a liability to pay.[783] Thus a provision is deductible if there is a legal or absolute liability for the business to pay. Therefore, not all provisions under accounting standards are tax deductible. If the expenditure will crystallise in a future period, such as provisions for leave passages, leave pay and warranty services, they do not qualify for deduction in the current period.

In accounting, a provision will need to be deducted in the income statement in the year incurred and shown as a liability in the balance sheet. If a liability does not meet the recognition criteria, then it is classified as a contingent liability. A contingent liability will not be recorded in the financial statements, but it will be disclosed in the notes to the accounts so that users of financial statements have clear information. To deal with the uncertain nature of a provision, MFRS 137 requires the provision to be reviewed annually at the end of the reporting period.[784] Adjustments should be made to reflect the current best estimate. Any increase in a provision is an expense and any reduction is a revenue item.

MFRS 119 *Employee Benefits* requires that the cost of providing benefits to employees be recognised in the period when an employee has rendered services in exchange for those benefits, not when the benefits are paid or payable.[785] There are two provisions that need to be made: short-term compensated leave, if the leave is allowed to be carried forward (provision for leave pay); and post-employment benefit in the form of defined contribution or defined benefit plans (provision for retirement benefit).

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[782] John Prebble, 'The Time Element in Deductions Cases' (1983) 13 *Victoria University of Wellington Law Review* 79, 83.
[783] Singh, *Veerinder on Taxation,* vol 2, above n 540, 646.
[784] IFRS Foundation, *MFRS 137 Provisions, Contingent Liabilities and Contingent Assets,* para 59.
[785] IFRS Foundation, *MFRS 119 Employee Benefits*, paras 11, 51.

The provision for retirement benefits is the amount payable to employees after they have ceased employment. This provision takes a range of forms, for instance a lump-sum payment such as a gratuity, a provident fund where employer (and usually employee too) has contributed throughout the employment period, or periodic payments such as a pension. Although the retirement will take place in the future, a provision needs to be made in the current period to match the payment that will be made in the future with the current services rendered by employees. The accounting treatment of provision for retirement benefits under the defined benefit plan is complex as it requires actuarial assumptions to measure the obligation, the expense and the actuarial gain or loss.[786] This is to ensure that the figure calculated is a precise estimate.

In *MWM Sdn Bhd v DGIR*, the Malaysian High Court held that provision for retirement benefits is not deductible as there are uncertainties inherent in the obligation to pay based on future events.[787] The expense crystallises in a future period when payment is made and therefore it is not eligible to be deducted in the current period. A deduction will only be allowed when the taxpayer is under a definite obligation to pay and does in fact pay in that year.

However, based on the *Exxon Chemical* case, the Court has more recently changed its view on this question. In this case, the Court of Appeal allowed a deduction for the provision of retirement benefits.[788] Based on a Privy Council decision in a Hong Kong case,[789] the Court held that the words 'expenses wholly and exclusively incurred' included a sum that the taxpayer is under an obligation to pay. The taxpayer was said to be under the obligation to pay in that case, as it was impossible for the taxpayer to lawfully resist any claim made by its employees. The Court also held that if there is no clear provision in the tax statute, it must be read strictly against the IRBM and in favour of the taxpayer. In his response to this decision, the DGIR issued a Decision Impact Statement to explain the consequences of this case. The Court's decision affects section 33(1) of the ITA 1967 only with respect to the term 'wholly and exclusively incurred'. Consequently, for a provision for retirement benefits to be allowable for tax purposes,

[786] IFRS Foundation, *MFRS 119 Employee Benefits*, para 55.
[787] *MWM Sdn Bhd v DGIR* [2000] MSTC 3778 (High Court of Malaya).
[788] *Exxon Chemical (Malaysia) Sdn Bhd v KPHDN* [2006] MSTC 4,204 (Court of Appeal).
[789] *Commissioner for Inland Revenue v Lo & Lo* [1984] 1 WLR 986 (Privy Council).

the fund must first be approved by the DGIR.[790] This action shows that the IRBM, in spite of the decision established in the *Exxon Chemical* case, is still reluctant to grant a deduction for future uncertain liabilities. But this also means that provision for retirement benefits made to an approved provident scheme is allowable for deduction.

Under normal circumstances, employers must recognise for accounting purposes the cost of all employee benefits, which include both those payable in money such as salaries and bonuses, and non-monetary benefits such as annual leave and medical benefits. Provision for leave pay is compensation payable to employees in the form of leave or a cash payment in lieu if there is any unexpended leave during the current period. A provision must be made only if leave can be accumulated and carried forward to the future period. In this event, it will be treated as an accrued expense, because it has been incurred (the employee has rendered service) but not yet paid (leave not yet taken). Not all unexpended leave is recognised as a provision. The calculation of the provision must consider the estimated unexpended leave that will not be used in the next year.

Provision for leave pay is also not tax deductible because it is a future liability, which arises only when payment is made. This issue has not been considered by the Malaysian courts. This provision was, however, held to be tax deductible in two separate cases in Australia and South Africa.[791] Interestingly, in these two countries, after the courts allowed deduction for the provision for leave pay, the legislation was amended to disallow deduction of provision for leave pay until payment has been made (section 51(3) of the *Income Tax Assessment Act 1936* in Australia, now superseded by section 26-10 of the *Income Tax Assessment Act 1997*,[792] and section 23E of the South African's *Income Tax Act 1962*).[793] As it transpired in the Australian case, the Commissioner of Tax appealed against the decision of the Victorian Supreme Court that

[790] ITA 1967, s 39(1)(d) provides that no deduction is allowed in respect of payments made to an unapproved pension or provident fund. This provision was not considered by the Court.

[791] *Nilsen Development Laboratories Pty Ltd v FCT* (1978) 78 ATC 4335 for the Australian case, and *Income Tax Case No 1516* [1991] 54 SATC 101 (Natal Special Court) for the South African case.

[792] Jacqueline De Fazio, 'Financial and Tax Accounting Differences: Product Warranties and Employee Leave Entitlements' (2009) 38(1) *Australian Tax Review* 29, 40.

[793] Susan Kroukamp, *Possible Tax Treatments of the Transfer of Accounting Provisions during the Sale of a Business and Subsequent Tax Considerations* (Masters Thesis, Stellenbosch University, 2006) 21 <http://hdl.handle.net/10019/1080>.

prompted the legislative intervention and succeeded in the Full Federal Court[794] and Full High Court[795] of Australia, which both held that the provision for leave pay is deductible only in the year in which payment is made.

The immediate government response to this issue as evidenced in Australia and South Africa indicates that the legislature has no intention to allow deduction of a provision for leave pay in the same year it is incurred for accounting purposes. It is likely that the government is concerned about the possible loss of revenue that would result from this tax treatment.[796]

Although no such cases have arisen in Malaysia, it is important to discuss the tax treatment of other provisions or future uncertain liabilities. In the case of provision for warranty claims, accounting standards require warranty claims to be matched with sales revenue. Therefore, a provision must be made because, although the actual claim has not occurred and the exact amount is still uncertain, it is certain that it will be incurred. Thus it can be recognised as an expense. In contrast, for tax purposes, the provision is not deductible because it is of a contingent nature. As tax requires precision, uncertain future expenditures should not be allowed for deduction. Warranty claims are deductible only when payment is made. It is not likely that this approach will change.

An interesting development which has taken place in Malaysia is the decision by the government to allow expenses incurred on warranty or defects liability by a construction contractor or a property developer to be deducted in a period prior to that in which the actual liability has been incurred.[797] In order to enjoy this facility, an irrevocable election must be made, which means if no election is made, the conventional approach still applies, that is, warranty expenses can only be deducted in the period the actual liability is incurred. However, this treatment still differs from the accounting approach since the actual amount must be certain before deduction can be

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[794] *FCT v Nilsen Development Laboratories Pty Ltd & Ors; Nilsen Development Laboratories Pty Ltd & Ors v FCT* (1979) 79 ATC 4520.

[795] *Nilsen Development Laboratories Pty Ltd & Ors v FCT* (1981) 81 ATC 4031.

[796] De Fazio, above n 792, 43.

[797] Income Tax (Property Development) Regulations 2007; Income Tax (Construction Contracts) Regulations 2007.

made, as opposed to accounting standards that allow deduction based on estimates and will adjust accordingly when the actual amount has crystallised. In addition, the new regulation allows warranty expenses to be deducted in 'the basis period preceding the basis period in which the expenses are incurred' with no reference made to the period of sale. This means warranty expenses can be deducted in any preceding period. Under accounting's matching principle, expenses must be matched with sales; hence warranty expenses can only be deducted in the period the sale was made.

Nevertheless, in a New Zealand case, the Privy Council held that the tax treatment of provision for warranty claims should follow accounting practices.[798] Liability was incurred in the year the sale was made. Hence the warranty claims should be deductible in the same period as sales. Conversely, the US Sixth Circuit Court of Appeals refused to grant deductions for anticipated warranty expenses in the year of sale.[799] The judges held that, although the amount of liability could be determined with reasonable accuracy, the event was still contingent in nature.

It is common for Malaysian courts to treat judicial decisions from other Commonwealth countries as persuasive. Decisions of the Privy Council must be given greater weight.[800] The current practice by the IRBM is to disallow deduction for a provision of warranty claims, with the exception of construction contractors and property developers. This practice is expected to continue until the issue is considered by a Malaysian court. It remains to be seen whether Malaysian courts will adopt the approach of the Privy Council to deductibility of warranty claims.

Several types of asset may require installation before they can be used, and when the assets are to be disposed of, owners must dismantle and remove the assets and restore their site. In accounting, the estimated future costs of dismantlement, removal and restoration must be included in the cost of assets.[801] The costs are to be depreciated

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[798] *Commissioner of Inland Revenue v Mitsubishi Motors New Zealand Limited* [1995] 17 NZTC 12,351 (Privy Council).
[799] *Chrysler Corp v Commissioner of Internal Revenue 436 F.3d 644 (2005)*.
[800] *Exxon Chemical (Malaysia) Sdn Bhd v KPHDN* [2006] MSTC 4,204 (Court of Appeal).
[801] IFRS Foundation, *MFRS 116 Property, Plant and Equipment*, para 16.

and/or tested for impairment in the same way as the original cost of the asset. A provision account is to be created as a long term liability.

These costs are also capital expenditure for tax purposes;[802] however, tax legislation does not allow the costs to be included in the initial cost due to its uncertain nature.[803] Instead, the costs are to be deducted when incurred (ITA 1967, schedule 3, paragraph 67C), which refers to the time when the asset is no longer in use and needs to be dismantled, removed or restored. Based on tax principles, incurred means the time at which the obligation to pay arises and the amount payable is certain. In contrast, the costs are recognised as part of the initial cost under accounting principles because the obligation to dismantle is said to arise when the asset was installed. Hence, the difference in the recognition time has caused a deferral of deduction, a negative tax expenditure.

It should also be noted that the tax deduction available for dismantling, removal and restoration expenditure is only available if such acts are required by written laws or agreement. If these costs are incurred voluntarily, and not under any law or agreement, they are not deductible and are permanent losses to the company. This is a denial of deduction, which is also a negative tax expenditure.

The same treatment is imposed in relation to other future uncertain liabilities, that is, they are deductible only after the liability crystallises, which in many cases is when the liability is paid. The question to be considered is when the liability crystallises. The word 'incurred' used in the Act is ambiguous and has been interpreted differently by the courts. Those who support a deduction after payment is made argue that liability crystallises when the event that leads to the payment occurred. This means that provision for retirement benefits crystallises when an employee actually retires. Before that, the payment is still contingent. It is possible, for example, that no payment will be made if the employee is terminated for disciplinary reasons. The same contingent character can be identified in warranty claims. The provision is made based on an

[802] Joint Memorandum by Malaysian Institute of Taxation, MIA and MICPA, *Minutes of Dialogue for Post 2009 Budget Issues*, 12 December 2008, para 8(i).

[803] Joint Memorandum by Malaysian Institute of Taxation, MIA and MICPA, above n 802, para 8(iv).

estimate and, no matter how accurate such estimates are, they are likely to differ from the precise amount of the eventual liability. Thus the amount deducted may be higher than the actual payment.

Where provisions and future expenditures are not allowed to be deducted for tax purposes in the same year in which deductions for accounting are made, the deferral of deduction is a negative tax expenditure. The difference between tax treatment of provisions and accounting practices is a timing issue. Based on a tax expenditure analysis framework, this difference does not relate in any way to the government's social and economic goals. It is also not a discouragement to spend. Provisions, or future uncertain expenditures, are negative tax expenditures because they defer deductions to a future period, often when the amounts payable become certain. Due to their uncertain nature, the legislature and tax authority are reluctant to allow a deduction for provisions in the same period in which they are deductible for accounting purposes. Provisions could be used by accountants in earnings management.[804] If provisions were allowable in computing taxable income, this would generate significant problems for the tax authority.[805] Although this may be the case, allowing deductions only after payment has been made means that the amount which is in fact taxable does not reflect the 'true' taxable profits earned by a business. Expenses incurred to generate an income are deducted long after the income was earned. The tax authority should formulate a mechanism to resolve this issue. Such a mechanism may be as simple as issuing additional or reduced assessments, similar to the procedure in the case of warranty claims for construction contractors and property developers. Alternatively, the solution could follow accounting practices, where the accounts are reviewed annually and the actual payment which has been made is compared with total provisions provided over the years. If the actual payment is greater, the difference is an expense; if the actual payment is lower, the difference will be adjusted by recognising revenue.

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[804] Manon Deslandes and Suzanne Landry, 'Taxable Income, Tax-Book Differences and Earnings Quality', (Paper presented at the 30th Annual Congress European Accounting Association, Portugal, 24 - 27 April 2007) 18 <http://www.archipel.uqam.ca/2148/1/Taxable_Income_and_Earnings_____Quality_ february_2007_ final.pdf>.

[805] Robert J Reid, 'When to Deduct - The Timing of Recognition of Business Expenses' in Canadian Tax Foundation, *Corporate Management Tax Conference: Current Development in Measuring Business Income for Tax Purposes* (Canadian Tax Foundation, 1981) 97, 115.

The current treatment of provisions in Malaysia is a result of judicial decisions. The legislation is silent; therefore the deductibility of provisions depends solely on judicial interpretations. However, the most recent development in judicial treatment of the issue, based on the *Exxon Chemical* case, has moved towards the financial accounting approach, where liability to pay is said to exist when the company lawfully cannot resist any claims.[806] This is a new approach in that previously courts examined the event that may cause the obligation. Using this new approach, there is a possibility that in the future more provisions will be held to be tax deductible on the basis that businesses cannot lawfully refuse these claims. This tax treatment appears to neutralise the negative tax expenditure of provisions. However, it is still unclear how the Court's decision will affect the tax treatment of various types of provisions in Malaysia. It is strongly recommended that the current treatment is improved either through changes in legislation or shift of view by the courts.

6.7 ADDITIONAL REVENUE

Sometimes, the government needs higher tax revenue to reduce the deficit in an annual Budget and to recover losses in revenue due to new tax expenditures introduced. This is usually achieved by imposing a higher income tax rate than the benchmark corporate tax rate of 25 per cent.

[806] *Exxon Chemical (Malaysia) Sdn Bhd v KPHDN* [2006] MSTC 4,204 (Court of Appeal).

6.7.1 Higher Income Tax Rate for Companies Involved in Petroleum Operations

Type	Higher tax rate
Brief Description	Income from petroleum operations in Malaysia is taxed at the rate of 38%.
Reason(s)	Source of government revenue.[807]
Effective Year	1967
Expiry Year	-
Source(s)	• PITA 1967, s 23(1)
Additional Information	'Petroleum operations' refers to searching for, and winning or obtaining petroleum by any drilling, mining, extracting or other like operations or process, and any sale or disposal of petroleum (including transportation cost within Malaysia), and in the case of Petronas, any sale or disposal of petroleum within Malaysia of petroleum obtained from outside Malaysia (including transportation cost within Malaysia).[808]

As the benchmark tax rate is 25 per cent, taxing companies involved in petroleum operations in Malaysia at a higher rate is a negative tax expenditure. Petroleum has become one of the major sources of revenue for the Malaysian government. In 2011 alone, a total of MYR 65.7 billion (AUD 21.9 billion) has been paid by Petronas, the government-owned oil and gas company, to Malaysia's federal and states governments through dividends paid, taxes, petroleum proceeds [the local term for royalties] and export duties.[809] This accounts for about 32 per cent of the government's total revenue. Tax revenue collected from PITA in 2012 almost reached MYR 32 billion (AUD 10.7 billion).[810] The higher tax rate is not to discourage petroleum operations in Malaysia, but simply to obtain more revenue to finance the nation's development. The additional tax is equivalent to a higher royalty for the government-owned oil company. For foreign firms, it is factored into the costs they charged under the production sharing

[807] Author's assumption, based on the fact that the Malaysian government relies heavily on petroleum-related revenues, as reported by Standard & Poor's Ratings Services, *Research Update: Malaysia Ratings Affirmed With Stable Outlook; External Liquidity Remains Strong* (27 July 2012) <http://www.standardandpoors.com/ratings/articles/en/us/?articleType=HTML&assetID=1245337923300#ID179>.

[808] PITA 1967, s 2.

[809] Petronas, *Petronas 2011 Annual Report*, 35.

[810] Ministry of Finance Malaysia, *Economic Report 2012/2013*, 125.

contracts they have with the government-owned oil company. In a sense, it is simply part of the cost of mining petroleum in Malaysia and since it is based on the amount extracted and sold, its impact on investment is the same as higher royalties or higher production sharing amounts would be. It is, however, less distortive of economic behaviour as it correctly reflects the differing costs of extraction in different situations, something that cannot be accommodated in a royalty based system.

6.7.2 Higher Income Tax Rate for Companies Involved in Petroleum Operations in the Joint Development Area

Type	Higher tax rate
Brief Description	Companies undertaking petroleum operations in the Malaysia-Thailand Joint Development Area are taxed at the rate of 20% after 15 years of production. They are required to pay 20% to each of Malaysia and Thailand, which means a total of 40%.
Reason(s)	Source of government revenue.
Effective Year	1995
Expiry Year	-
Source(s)	• PITA 1967, s 23(2) • The Protocol to the Malaysia-Thailand Double Tax Agreement, Article 7A (2)
Additional Information	-

For the first 15 years of operation, companies involved in petroleum operations in the Malaysia-Thailand Joint Development Area are taxed at a concessional tax rate. Afterwards, they are required to pay a 40 per cent petroleum income tax, consisting of 20 per cent to each of Malaysia and Thailand. As a joint development area, the petroleum in the area is assumed to be shared equally between the two countries. Therefore, half of the income is derived from Malaysia, and the other half is derived from Thailand. The charge of 20 per cent income tax by each country could effectively mean that half of the income is taxable at the rate of 40 per cent in Malaysia, while the other half is also taxed at 40 per cent by Thailand.

Thailand's petroleum income tax rate is 50 per cent, higher than Malaysia's 38 per cent tax rate. The 40 per cent rate adopted in the joint development area is believed to be the

compromise rate between the two different rates. This gives Malaysia the opportunity to gain an 'additional royalty' on its natural resources, higher than the usual 38 per cent tax.

6.7.3 Higher Income Tax Rate for Dividend Income from Petroleum Companies

Type	Higher tax rate
Brief Description	Under the single-tier tax system, a company's profit is taxed at the company level and dividends received by shareholders are exempt from tax. When a company owns shares in a petroleum company, the dividends received are taxed at the rate of 38%.
Reason(s)	To improve efficiency and simplify the administration of corporate tax.[811]
Effective Year	2008
Expiry Year	-
Source(s)	• ITA 1967, s 108; sch 6, para 12B
Additional Information	-

Malaysia appears to accept the view that corporate income is taxed on shareholders as the owner and company is merely a collecting agent for tax on dividend income, and that it is not justifiable for the government to impose a separate and second tax on the income. Commencing in 2008, Malaysia has moved from full dividend imputation to a single-tier structure as its corporate-shareholder integration system.[812] Under the previous imputation system, a company was required to maintain a 'section 108' account (a memorandum account), which was used to keep track of the amount of tax deducted from dividends paid to shareholders. Dividends could only be paid if tax had been deducted; however, if profits came from non-taxable income, such as capital gains, it could not be used to pay dividends. Moreover, maintaining the section 108 account increased compliance and administrative costs for both companies and the IRBM.[813]

In order to simplify the tax system and to maintain tax competitiveness (neighbouring country Singapore implemented the new system a few years earlier), the government

[811] Malaysian Budget Speech 2008, paras 11-12; Appendix 1.
[812] For a discussion of corporate-shareholder integration systems, see Section 3.2.2(iii).
[813] Malaysian Budget Speech 2008, paras 11-12; Appendix 1.

moved to a single-tier system, also known as dividend exclusion system. Despite the simplicity, the new system has resulted in dividends being taxed at company level. Dividend is income to shareholders; therefore, it should be taxed at shareholder level applying their respective tax rates based on ability-to-pay. In most cases involving corporate shareholders with the same tax rate as the payor company, neither tax expenditures nor negative tax expenditures would arise from this tax treatment. However, when a standard company owns shares in a petroleum company, dividend income is taxed at the rate of 38 per cent, higher than the 25 per cent benchmark tax rate. Consequently, this results in a negative tax expenditure. While the higher tax rate for petroleum company is a sensible policy to compensate for the extraction of the country's non-renewable resources, this rationale would not extend to investment income. The appropriate tax rate for investment income should follow the benchmark. This thesis recommends that an amount reflecting the 13 per cent additional tax needs to be refunded to shareholders.

6.8 DISINCENTIVES NOT REGARDED AS NEGATIVE TAX EXPENDITURES

Some tax treatments, although they provide disincentives to companies by denying deductions, are not regarded as negative tax expenditures because they are part of the benchmark. This thesis has found a denial of deduction that is not classified as a negative tax expenditure because it forms part of the anti-tax avoidance measures included in the income tax, namely the denial of deduction relating to charitable donations.

6.8.1 Denial of a Deduction for Donations to Charity

Companies are expected by the government and general public to fulfil their duties relating to corporate social responsibility. Donation to charity, or philanthropy, is one of the common ways to achieve this. Accounting principles would simply allow deduction for charitable donations made by companies. It is part of the cost of doing business, and could bring benefits to companies by way of marketing and improved

goodwill.[814] In taxation, charitable donations are generally not tax deductible on the basis that they are not related to income earning activities. Nevertheless, the government does provide a few exceptions to encourage companies to become involved in charity and enhance the culture of corporate social responsibility.[815] These donations can be used to reduce the tax payable. The approved donations are:[816]

(i) Provision of library facilities which are accessible to the public and contributions to public libraries and libraries of schools and institutions of higher education, but limited to MYR 1,000 (AUD 330);

(ii) Provision of services, public amenities and contributions to a charity or community project pertaining to education, health, housing, infrastructure and ICT;

(iii) Provision of infrastructure in relation to business which is available for public use,

(iv) Cash contribution made to the government, a state government, a local authority, approved institution/organisation, and cash and in kind contribution to approved sports activity, sports body or other project of national interest, but limited to 10 per cent of aggregate income;

(v) An artefact, manuscript or painting donated to the government or state government;

(vi) Cash contribution to public libraries, or libraries of schools or higher education institutions, but limited to MYR 20,000 (AUD 6,700);

(vii) Cash and in kind contribution for public facilities that benefit disabled persons;

(viii) Medical equipment donated to an approved healthcare facility, but limited to MYR 20,000 (AUD 6,700);

(ix) Painting donated to the National Art Gallery;

(x) Business zakat (a religious charity contribution that is mandatory for Muslims), but limited to 2.5 per cent of aggregate income.

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[814] Nancy J Knauer, 'The Paradox of Corporate Giving' (1994) 44(1) *DePaul Law Review* 1, 60-74.

[815] *Malaysian Budget Speech 2009*, para 59; Appendix 10.

[816] ITA 1967, ss 34(6)(g), 34(6)(h), 34(6)(ha), 44(6), 44(6A), 44(7), 44(8), 44(9), 44(10), 44(11), 44(11A), 44(11B), 44(11C).

Accounting and taxation have different views on the nature and the treatment of this expense. Which is correct? Is a donation to a charitable body a business expense? To answer this question, it is important to justify whether a charitable donation has its nexus to income earned. Unlike donations made by individuals which are an act of altruism, it is hard to accept that profit-seeking organisations would act out of the same motivation.[817] Many people believe that companies participate in charitable contributions with the goal of improving their bottom line.[818] Whether this objective is achieved is another matter, in the same way that any of the other actions and activities undertaken by companies could go wrong. It is the intention that is important, and as the intention is to increase income, it has a clear nexus to income earned.

Since it is a business expense, denying deductibility for charitable donations suggests a negative tax expenditure. Tax legislation, nevertheless, in fact allows certain charitable donations, with some deductible donations subject to restrictions. Provisions relating to the control over which donations can be tax deductible could be considered to fall within the scope of anti-tax avoidance measures, which are part of the benchmark. Limiting the beneficiaries to approved institutions is needed to overcome the risk of abuse of the provision. The control is essential to ensure beneficiaries are completely legitimate, and are not fictitious organisations that are used to provide tax-free benefits to the company's directors or used in money laundering activities.

There are also certain limits to the deductible donations. Cash contributions to approved institutions are restricted to 10 per cent of aggregate income, and donations to libraries and healthcare facilities are restricted to MYR 20,000 (AUD 6,700).[819] These restrictions can also be argued to be within the anti-tax avoidance framework. Companies are expected to perform their corporate social responsibility functions, but

[817] Geoffrey B Sprinkle and Laureen A Maines, 'The Benefits and Costs of Corporate Social Responsibility' (2010) 53(5) *Business Horizons* 445, 446.

[818] Herman Aguinis and Ante Glavas, 'What We Know and Don't Know about Corporate Social Responsibility: A Review and Research Agenda' (2012) 38(4) *Journal of Management* 932, 943; Paul C Godfrey, Nile W Hatch and Jared M Hansen, 'Toward a General Theory of CSRs: The Roles of Beneficence, Profitability, Insurance and Industry Heterogeneity' (2010) 49(2) *Business & Society* 316, 336.

[819] The business zakat is limited to 2.5 per cent of aggregate income but this is not considered as part of the anti-tax avoidance measures. The rate for zakat is 2.5 per cent, thus there is no reason to pay more than this.

at the same time they have a larger responsibility to their shareholders. The restrictions suggest the government's expectation as to how much should be donated to be regarded as socially responsible. A higher donation could imply an illegitimate donation or disguised untaxed consumption by someone else.

As the restrictions and controls over donations are within the scope of anti-tax avoidance measures, they do not give rise to a negative tax expenditure, but rather are an administrative procedure to protect the integrity of the tax system.

6.9 SUMMARY

The purpose of this chapter has been to achieve the third objective of this thesis, that is, to determine whether a negative tax expenditure should be removed, maintained or modified, using the conventional tax expenditure analysis. Most of the negative tax expenditures involve non-allowable deductions, which mean they are regarded as business expenses under accounting principles, but are not allowed to be deducted in the calculation of taxable income.

There are three main reasons for the denials of a deduction and restricted deductions. The first reason – capital nature and non-income related – is a general provision that is used in many countries. It usually requires judicial interpretations to resolve the issue of whether an item is of a capital nature or non-income related and hence not deductible, or vice versa. Nevertheless, different judges have different opinions; judges in more recent times have a tendency to be more lenient in their interpretations. These negative tax expenditures do not provide support for any economic or social objectives or deterrence from any activities, but rather arise from a strict interpretation of tax law. It is highly recommended that the government reviews these provisions to better reflect the nature of modern businesses instead of relying upon judicial decisions made centuries ago.

The second reason for denials of a deduction and restricted deductions is to minimise potential tax revenue losses. Most of the negative tax expenditures in this category are

surrogate taxes, which were introduced due to the difficulties in taxing the beneficiaries. Thus the government is required to use the alternative, to impose tax on the providers of the benefits, that is, the businesses. These negative tax expenditures are also to prevent misuse of deduction facilities given to companies. They can be argued to be legitimate negative tax expenditures and so could be maintained.

Several expenses are business expenses incurred to produce income, but because they are related to government disfavoured activities, they cannot be deducted. This is the third reason for the denials of deduction. These provisions do have genuine reasons. However, while some of the provisions have been caught by section 39 of the ITA (section 39 lists non-allowable deductions and these items mainly represent certain activities which are discouraged by the government), there are negative tax expenditures that depend on the unsubstantiated argument of application of the description of 'capital expenditure and non-income related'. They should instead be explicitly legislated.

Another negative tax expenditure is the deferral of deduction that arises due to timing differences as a result of the differing applications of the word 'incurred' in accounting and taxation, and the higher tax rate imposed on petroleum companies. These negative tax expenditures relating to timing are another result of judicial interpretations, and this thesis proposes that they need to be reviewed by the legislature to allow the tax treatment to follow accounting practices. Finally, negative tax expenditures could also be due to application of a tax rate that is higher than the benchmark. The higher tax rate payable by petroleum companies is acceptable as an 'additional royalty', but should not be extended to investment income.

In addition, included in this chapter are the measures involving the denial of a deduction that are not considered as negative tax expenditures because they are considered to fall within the scope of anti-tax avoidance measures, which form part of the benchmark used in this thesis.

CHAPTER SEVEN

CONCLUSION

7.1 INTRODUCTION

The main purpose of tax legislation is to set out the rules for the basis of tax calculation. This is applicable in Malaysia. The general rule, as laid in the ITA 1967, is very simple; income is calculated by deducting from the gross income expenses incurred to produce it.[820] However, over the years, as the government has tried to encourage taxpayers to undertake preferred activities and to discourage certain undesirable actions, various 'distortions' in the form of allowances, double deductions, income exemptions and denial of deductions have been introduced in the legislation. As a result, tax computation has become a complex task, and the tax base has become narrower. The government has, in response, been forced to impose a higher nominal rate of tax than would otherwise be necessary to recover the loss of tax revenue. The higher rate of tax affects the low and middle-income earners most, since high-income groups usually can enjoy a lower effective tax rate by taking advantage of the tax expenditures available.

As the concept of tax expenditures introduced by Surrey more than 40 years ago has not reached Malaysia, policymakers have mistakenly focused their analysis from the view of the revenue part of the fiscal system. The tax expenditures should, in fact, be analysed as government allocation programs, since they are equivalent to direct spending programs.[821] There is an urgent need for a tax expenditure report and analysis for Malaysia. A tax expenditure report should not only identify the government's indirect spending, but also disclose the extent of the loss of tax revenue caused by each tax expenditure. This report could and should be used as the basis for the introduction

[820] ITA 1967, s 33(1).

[821] David F Bradford, 'Tax Expenditures and the Problem of Accounting for Government' in Neil Bruce (ed), *Tax Expenditures and Government Policy* (John Deutsch Institute for the Study of Economic Policy, Queen's University, Ontario, 1988) 427, 429; Shaviro, above n 87, 187-188.

of any tax expenditure, and the assessment of whether better strategies, such as direct spending or government regulations, could be used to achieve the government's objectives in a more efficient manner.

Despite Surrey's tax expenditure concept receiving numerous criticisms, many governments in the world, including most OECD countries and developing countries such as India and South Africa, accept the concept and follow Surrey's appeal to report on their tax expenditures as part of good governance practices. Unfortunately, in several reports, the outcomes of Surrey's ideal tax expenditure analysis — that 'bad' tax expenditures are repealed or converted into direct spending — have not been realised, probably for political reasons. Nevertheless, this should not in any way suggest that tax expenditure reporting should be discontinued. The general consensus still prefers some kind of publication that can provide essential budgetary information to policymakers and enable the public to assess the government.

This thesis adds to existing literature on Malaysian tax policy by analysing current aspects of taxation law from a tax expenditure perspective. It is also among the first studies on tax expenditures that proposes the use of accounting standards as the benchmark tax base for identifying corporate income tax expenditures and the extensive analysis of negative tax expenditures. Tax expenditures and negative tax expenditures identified in this thesis are not restricted to those arising from tax legislation, but also include implicit tax expenditures from judicial decisions and administrative practices.

The thesis starts with a brief overview of Malaysia's accounting and tax systems, which provides basic knowledge necessary for understanding subsequent discussions (Chapter Two). Since the concept of tax expenditures is unfamiliar among many Malaysians, Chapter Three explores the concept and gives a general idea of its substance and importance, as well as exploring other related issues such as measurement and reporting. The thesis later proposes the elements of the tax expenditure benchmark to be used in the identification of corporate income tax expenditures, in which this thesis chooses accounting standards and practices as the benchmark tax base over the widely used S-H-S concept of income.

Since tax expenditures are substitutes to government direct spending, the expenses identified in this thesis are categorised the same manner direct expenditures are categorised in the annual federal budget estimates — based on their functions (however, for the purpose of presentation, this thesis used different function groups from those used by the government). These tax expenditures, gathered from all sources of tax law, including court cases and tax office rulings, are critically analysed (Chapters Four and Five). Using the same elements of the tax expenditure benchmark, this thesis also identifies corporate negative income tax expenditures and questions the reasoning used to impose them (Chapter Six). Concluding remarks for these chapters are provided in subsequent sections.

7.2 ACCOUNTING STANDARDS AS THE TAX EXPENDITURE BENCHMARK

This thesis offers a new insight on corporate income tax expenditure analysis by using accounting standards as the benchmark tax base instead of the widespread S-H-S concept of income. It has been established in this thesis that using accounting standards as the base is simple and practical, yet it produces a comprehensive list of corporate income tax expenditures and negative tax expenditures that require attention and further scrutiny.

One strong case to support the use of accounting standards is their adaptability to today's business activities, facilitated by their constant review. This review process is a practice not available in the tax system. This thesis has identified several out-dated tax rules that require immediate revision and a few judicial interpretations that do not fit in the present business world. Consequently, the use of accounting standards as a benchmark does not only produce a list of corporate income tax expenditures and negative tax expenditures, but also other tax incentives which are, in fact, day-to-day business expenses that must be recognised in the ascertainment of profits.

It is acknowledged that the idea of making accounting standards the basis for the calculation of corporate income tax has been opposed, particularly from experts in economics and law. However, the proposal of using accounting standards in this thesis is restricted to adopting the standards for the purpose of identifying and analysing tax expenditures, not for the overall calculation of corporate taxable income. Nevertheless, it is up to the legislature to maintain items identified as tax expenditures and negative tax expenditures but are considered necessary to meet the objectives of taxation.

7.3 CORPORATE INCOME TAX EXPENDITURES IN MALAYSIA

As can be seen from Chapters Four and Five, Malaysia has a large number of corporate income tax expenditures, some of which have been in legislation for decades without revision. There has been a lack of subsequent analysis of the extent to which the tax expenditures have accomplished their objectives. The aims of economic tax expenditures are, mainly, to improve the country's balance of payments accounts by strengthening local products so they can be exported and the country can reduce imports, and to attract more foreigners to spend in the country either through investment or by way of tourism. In every budget announcement, the government introduces more tax expenditures to attract foreign investment, although many studies have found out that foreign investors have not sought the tax incentives, and they have no significant impact in attracting foreign investment. The most sought-after factors are the general features of the tax system, such as the tax base and the tax rates, and the legal and regulation system of the country.[822]

The objectives of social tax expenditures do not usually directly benefit companies, which is why the government believes tax expenditures are needed to encourage private sector participation. The socially preferred activities, however, do actually benefit

[822] David Holland and Richard J Vann, 'Income Tax Incentives for Investment' in Victor Thuronyi (ed) *Tax Law Design and Drafting* (International Monetary Fund, 1998) vol 2, 986, 987-989; Howell H Zee, Janet G Stotsky and Eduardo Ley, 'Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries' (2002) 30(9) *World Development* 1497, 1510; David Lim, 'Fiscal Incentives and Foreign Direct Investment in Less Developed Countries' (1983) 19(2) *The Journal of Development Studies* 207, 210-211; Quan Li, 'Democracy, Autocracy, and Tax Incentives to Foreign Direct Investors: A Cross-National Analysis' (2006) 68(1) *Journal of Politics* 62, 72.

companies in the long term, although the benefit is more indirect. Apart from offering tax incentives, it is important for the government, together with non-profit organisations and the public, to increase awareness among companies to take part in creating a better future.

Generally, the Malaysian government offers tax expenditures to corporate taxpayers with the following objectives:

a. *Promote government-preferred activities.* The government provides tax expenditures for activities that are viewed by the government as essential for the economic and social development of the country. However, in most cases, government intervention is unnecessary because the government-favoured activities are also preferred by companies. They would still be involved in the activities even if no tax expenditures were available. A few activities require government intervention, though the design of the existing tax expenditures has missed the targeted group.

b. *Reward for successful companies.* Several tax expenditures can only be claimed if companies have successfully achieved a particular target set by the government. The reward is given to motivate companies to increase their productivity and work harder. However, companies are naturally motivated by profits. The whole purpose of running a business is to earn as much profits as possible. Since all the rewarded actions would lead to increase in profits anyway, the tax expenditures are redundant.

c. *Attract investors.* Some tax expenditures are given to attract foreign investment into Malaysia, particularly in a few specified areas. Nevertheless, in most cases, a tax incentive is not a factor considered by the investors. They are looking for factors that can support their businesses in the long term, such as availability of facilities, infrastructure and skilled workers.

d. *Reduce cost of doing business.* Tax expenditures are also given to companies as financial assistance to reduce the burden of high capital expenditures or the rising daily operating costs that make companies struggle to survive in the market. Unfortunately, the existing tax expenditure designs often fail to help struggling companies. Instead, much of the benefit is enjoyed by profitable companies.

A few tax expenditures are given not for the objectives stated above but are inherited from the British tax system. They are accepted as common features of an income tax system but have not been thoroughly reviewed. These practices have, however, been departed from by many Commonwealth countries, including the UK itself, several years ago.

Overall, the arguments made against the use of tax expenditures stand true in Malaysia. The upside-down effect is obvious; tax expenditures with the original intention to offer assistance to struggling companies end up providing more help to profitable companies. Loss-making companies could not enjoy the benefit, or at least have to wait until they are profitable again to be able to claim the tax expenditures. Besides, unlike direct expenditures that are enacted with a certain ceiling that limits the amount that can be spent by the government, tax expenditures are designed with no ceiling. Hence, the government's indirect spending is indefinite. Since no tax expenditure report is available, the government is clueless about how much money has been indirectly spent to support a particular objective. The public too has not been able to assess how well the government has managed its resources.

Obviously, the availability of tax expenditures has complicated the tax system. Often for a given activity there is more than one tax expenditure that can be claimed by companies. This complexity has increased tax compliance costs for companies. The denial of a deduction for most of the compliance costs adds a burden. Another problem with tax expenditures is their possibility to be forgotten by the government and left in legislation without review. This problem has been identified by this thesis for a number of tax expenditures.

Currently, Malaysia's corporate income tax expenditures are given as income exemptions, double deductions, allowances (mostly pioneer status and investment tax allowance), tax deferrals and preferential tax rates. Any new tax expenditures announced by the government also usually fall within these five categories. However, the designs of each tax expenditure type are flawed, as they often missed the needy group. These flaws are inherited by any new tax incentives announced by the government. There has been little effort by the government to create a new tax expenditure design that would properly target only the needy group. This could be the result of Malaysia's political scenario, where the same political party has ruled the country since Malaysia's independence from the British administration in 1957. Except for the two previous general elections in 2008 and 2013, the current ruling party has always won a two-third majority in parliament, allowing new legislation to be passed with minimal effort.

7.4 CORPORATE NEGATIVE INCOME TAX EXPENDITURES IN MALAYSIA

Corporate negative income tax expenditures make companies pay increased tax as a result of being involved in certain activities. Some negative tax expenditures are introduced to prevent or restrain companies from undertaking disfavoured or illegal activities. Others, however, are simply introduced to allow the government to obtain a higher share of revenue. For example, the high income tax rate imposed on petroleum companies does not mean that the government wants to discourage petroleum operations, but rather to obtain higher share of profits, since oil and gas are considered as the nation's assets.

On top of these 'intentional' negative tax expenditures, however, there are others that are inadvertently embedded in the tax system as a result of strict judicial interpretation of tax rules. They are either not allowed to be deducted at all and become a permanent loss to the companies, or deductions are allowed but at a later period compared to what is practised in accounting. The government has realised this shortcoming of the current tax law in today's business world. Slowly, the unintentional negative tax expenditures

have been declared as incentives to make them deductible by businesses without the government having to change the general deductibility rules in the legislation.

In addition, some negative tax expenditures are imposed as a proxy tax, where corporate taxpayers act as the 'collecting agent' on behalf of the real beneficiaries, as it is administratively impractical to impose tax on the income received by the latter.[823] Hence, taxpayers are not allowed to deduct the expenses for tax purposes.

7.5 RECOMMENDATIONS FOR THE GOVERNMENT

The lack of data and information to extensively analyse Malaysian tax expenditures shows how urgent the need is for a publication of a tax expenditure report in Malaysia. Hence, it is highly recommended that the government commence efforts to produce a tax expenditure report and disclose all key information as proposed by the IMF and other tax scholars.

The government can follow the steps to implement tax expenditure reporting explained in Section 3.2.5. This thesis has undertaken three of the steps with regard to corporate income tax expenditures, proposing the elements of the benchmark, identifying and classifying the tax expenditures, and identifying and classifying the negative tax expenditures. They are readily available to be adopted by the government. The government should carry on with the remaining two steps; to measure the tax expenditures and to publish a periodical tax expenditure report. It is most preferable that the government includes all types of taxes in the tax expenditure report. The report should then be used to analyse the tax expenditures. If any of the tax expenditures are ineffective or not cost effective, actions must be taken to amend or remove them.

[823] These negative tax expenditures are discussed in Section 6.4. An example includes the restricted deduction for some entertainment expenses incurred by a company, as it is impractical for the government to tax the recipients of the benefits.

Besides producing a tax expenditure report to analyse existing tax expenditures, this thesis also proposes that before the government decides to introduce a tax incentive, it should first be analysed as a tax expenditure. One of the main considerations is the reason for choosing a tax expenditure as the method to deliver assistance instead of using direct spending or government regulation. A careful investigation must be undertaken to ensure the tax expenditure's beneficiary really is the needy group, that is, the low-income individuals and loss making companies, not rich people and highly profitable companies.

Furthermore, based on the observation of tax expenditures in this thesis, new tax expenditures should first be established by way of sunset legislation, that is, measures with specified lives of between three and five years. During the sunset period, extensive review, monitoring and evaluation must be undertaken to investigate the outcome — whether the tax expenditures have been effective and how much has been indirectly spent by the government as a result of them. Only tax expenditures that can achieve the intended objectives and use the optimum level of government resources should stay in the tax system. Nonetheless, they must be analysed and reviewed regularly to assess their relevancy. Today's world is fast changing and there are a lot of factors that can modify taxpayers' behaviour and render a tax expenditure irrelevant. To the extent possible, tax expenditures can be designed with "future proofing" characteristics that provide the opportunity for quick change as needed.

This thesis also reveals that there are provisions in the Malaysian tax legislation that are out-dated and do not reflect the reality in the present world. A number of expenses which are conventionally not allowed for deduction due to the "wholly and exclusively incurred in the production of gross income"[824] rule are actually normal costs of doing business. Some judicial decisions are based on precedent cases made before the World War I. These have resulted in a rigid application of income tax compared to the application in other advanced economies. Much of the problem rooted from the application of section 33(1) of the ITA 1967, which was inherited from the British

[824] ITA 1967 s 33(1).

Income Tax Ordinance 1947.[825] The business world has since evolved dramatically. The phrase made with small and simple 1947 businesses in mind is unable to accommodate transactions made in the current complex corporate world.[826]

Since the existing tax expenditure designs adopted by the Malaysian government are flawed and have often missed the "needy" group, it is advisable that assistance is offered as grants or loans that could correctly reach the targeted group. Grants have the added benefit of transparency, and the spending incurred can be controlled and monitored. If for any reason the assistance must be disbursed via the tax system, a new design for tax expenditures must be developed. The new design must be able to properly target the group that needs to be assisted, while the high-income group should receive lesser benefit or no benefit at all. One possible design is the tax credit, with refundable facilities provided only to the low- and middle-income groups.

While many of the existing tax expenditures aim to attract foreign investors, research has established that tax incentives are not the main factors considered in investment decisions.[827] Rather than using tax incentives to attract foreign investments, it is preferable for the government to reform the current tax system in Malaysia to remove all anomalies. The tax base could be widened by removing the tax expenditures, and a low tax rate is preferred. In addition, the government should allocate more resources to other relevant factors, such as infrastructure and human capital, which should in the long term bring more investors into Malaysia and bring in more tax revenue (of course, in absence of tax expenditures).

There are a lot of tax expenditures and negative tax expenditures that should be revised. Most of them, however, require further studies to find the indirect costs incurred by the government to be compared with the benefits that flow into the country. Nevertheless,

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[825] The *Income Tax Ordinance 1947* was drafted by the British based on the *Model Colonial Territories Income Tax Ordinance 1922* for application in Malaya and Singapore. For further discussion on this, see Section 2.4.

[826] Khoo Chuan Keat, PwC Malaysia, *Tax Deductibility of Business Expenses* <http://www.pwc.com/my/en/issues/tax-deductability.jhtml>.

[827] Holland and Vann, above n 822, 987-989; Zee, Stotsky and Ley, above n 822, 1510; Lim, above n 822, 210-211; Li, above n 822, 72; James B Ang, 'Determinants of Foreign Direct Investment in Malaysia' (2008) 30 *Journal of Policy Modeling* 185, 188.

the government can take immediate actions on tax expenditures and negative tax expenditures that are irrelevant and flawed in design. Items such as tax exemption on income of foreign companies attained from trading in Malaysia through consignees in specific commodities (Section 4.10.3) which is already out-dated can be removed from the legislation without much hassle. Tax expenditures and negative tax expenditures that are inherited from the British tax system but no longer suits today's business world, for instance the current capital allowance scheme for tangible and intangible assets (Sections 4.11.1 (e), 6.3.1 and 6.3.2) and the requirement of "wholly and exclusively incurred in the production of gross income" to be eligible for tax deduction (Sections 6.3.4, 6.3.5, 6.3.6, 6.5.1 and 6.6.1) render a need for immediate attention from the government. Given the high number of tax expenditures in the form of pioneer status, it is imperative for the government to review the current design of pioneer status as soon as possible since the current design failed to benefit companies that are in need of government assistance.

7.6 RECOMMENDATIONS FOR FUTURE RESEARCH

To date, accounting theory tax expenditure analysis has relied on ad hoc benchmarks constructed specifically for the purpose of tax expenditure analysis. This study adopts a new approach, substituting accounting standards for the benchmark to ensure it is based on independently developed objective principles for the accurate measurement of profits. This benchmark is then used for the first comprehensive analysis of tax expenditures and negative tax expenditures in Malaysia. There are many areas that require further research and investigation. First, since this thesis concentrates only on corporate income tax, similar research on other types of taxes in Malaysia, such as personal income tax, sales and services taxes and import duty, can be undertaken to analyse the tax policy adopted by the government from the perspective of tax expenditure analysis. In order to do so, the elements of the benchmark tax base for each type of tax must first be developed.

The analysis of tax expenditures in this thesis is limited, mainly due to the unavailability of data regarding the revenue forgone due to the tax expenditures, and the lack of studies on how effective the current tax expenditures are in achieving their objectives. The measurement of revenue forgone can only be offered by the government, or under the government's consent, because only the government has access to the data needed to calculate the amount of revenue forgone. On the other hand, public researchers can conduct a study on the effectiveness of tax expenditures. Not much research has been done in this area, particularly for Malaysian tax expenditures or tax incentives. Various tax expenditures, such as pioneer status, investment tax allowances and accelerated capital allowances need to be critically analysed. This kind of research, however, cannot be left only to the government. Rather, it may require joint investigation by the government and experts from academia and other fields.

Further research is also essential to find the critical success factors or determinants that contribute to achieving intended government objectives. For example, the government is offering tax expenditures to encourage employers to hire disabled persons as employees. Based on statements made by several individuals, including the Ministers in the local newspapers, employers are still reluctant to hire disabled persons. Hence, studies need to be undertaken to investigate why employers are reluctant to employ this group. Is it the perception by the employers that people in this group cannot perform well in their employment? Or is it because people in this group lack skills? Do employers want more financial incentives from the government? The research findings can assist the government to understand the original problems and formulate policies that can solve these problems. The results from such research can guide the government to develop a better policy that carefully aims at the real problem in each case. Another example relates to the task of finding the factors that contribute to the success of Malaysia being tagged as an Islamic finance hub. If tax expenditures have no influence towards the success, and Malaysia could still be the Islamic finance hub even without the tax expenditures, there is no purpose of the government losing tax revenue.

Another interesting line of research would be a comparative analysis between countries on efforts to achieve a particular objective where Malaysia has chosen tax expenditures as the way to deliver assistance. Comparisons with other developed countries, such as Australia, Canada, New Zealand and the U.S. and with other emerging economies such as Mexico, Indonesia, India and South Africa could provide exciting and useful information to guide Malaysia to formulate a better policy in the future and better manage its resources.

New research could also be undertaken on areas identified as tax expenditures and negative tax expenditures in this thesis, that have been accepted as part of the common features of Malaysia's tax system. Items like a tax exemption on capital gains, unavailability of capital allowance for certain types of business assets, the initial capital allowance and the issue of 'non income producing activities' need to be critically explored and analysed to find out the justification of the practices and whether they are still relevant in this new era.

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