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EY Tax Alert

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Malaysian developments

Case law on the claim for industrial building allowance (IBA) and increased export allowance (IEA)

In Ketua Pengarah Dalam Negeri v Classic Japan (M) Sdn Bhd (2022) MSTC 30-476, the Court of Appeal (CoA) overturned part of the decision of the High Court (HC). The CoA concurred with the HC's position that the taxpayer was entitled to claim IBA as the taxpayer's factory qualifies as an industrial building under Paragraph 63 of Schedule 3 of the Income Tax Act 1967 (ITA). The CoA however disagreed with the HC's position that the taxpayer was entitled to claim IEA, as the taxpayer was not directly "engaged in agriculture" per Rule 3 of the Income Tax (Allowance for Increased Export) Rules 1999 (1999 Rules)[1]. The CoA also disagreed with the HC's position that the Director General of Inland Revenue (DGIR) had no legal or factual basis to impose penalties under Section 113(2) of the ITA, as the taxpayer had indeed provided incorrect information and failed to declare its income correctly.

[1] The 1999 Rules have been revoked and replaced by the Income Tax (Exemption) Order (No. 6) 2019 [P.U.(A) 162]

An overview of the case and discussion of the issues are set out below.

Overview

The taxpayer is a Malaysian-incorporated company which is in the business of collecting, processing and shipping cut fresh flowers for export to Japan. The taxpayer has been involved in this business since 2006.

The taxpayer purchases fresh flowers from contract growers in Cameron Highlands. In 2006, the taxpayer also built a factory, where processing works (e.g., inspecting, trimming, grading, bunching, cutting, hydrating, packaging etc.) are carried out to ensure the flowers are preserved and meet the necessary standard and quality.

The increased value of the taxpayer's export of fresh flowers and capital expenditure incurred for the construction of the factory are as follows:

Year of assessment (YA)	Increased export
2007	4,753,570
2008	2,908,660
2009	2,231,552
2010	4,470,958

YA	Capital expenditure
2007	812,400
2008	329,604
2010	18,314

The taxpayer claimed IEA and IBA from YA 2007 to YA 2010.

The chronology of events thereafter are as follows:

26 July 2011	The IRB conducted a tax audit on the taxpayer
10 January 2013	The IRB issued two Notices of Assessments (for YA 2008 and YA 2009) and a Notice of Additional Assessment (for YA 2010), including penalties
23 January 2013	As the taxpayer did not agree with the assessments, the taxpayer filed an appeal by way of Form Q to the Special Commissioners of Income Tax (SCIT)
8 April 2016	The SCIT held that: (i) The taxpayer was not entitled to claim the tax incentive under the 1999 Rules (ii) The taxpayer's factory is an industrial building within the meaning of Paragraph 63, Schedule 3 of the ITA (iii) The DGIR was entitled to impose a penalty under Section 113(2) of the ITA Both DGIR and the taxpayer appealed the SC's decisions to the HC.
2 February 2021	The HC delivered a judgment in favour of the taxpayer by allowing the taxpayer's appeal and dismissing the DGIR's appeal. The HC held that: (i) The taxpayer was entitled to claim the IEA under the 1999 Rules (ii) The taxpayer's factory is an industrial building within the

	meaning of Paragraph 63, Schedule 3 of the ITA, and as such entitled to claim IBA (iii) The DGIR had no legal or factual basis to impose the penalty under Section 113(2) of the ITA The DGIR appealed the HC's decisions.

The issues for the CoA's determination were as follows.

Whether the taxpayer was entitled to claim the IEA under the 1999 Rules

The CoA disagreed with the HC's position and held that the taxpayer was not entitled to claim the IEA under the 1999 Rules. The CoA referred to the decisions in Dr Koay Cheng Boon v Majlis Perubatan Malaysia [2012] 4 CLJ 445 and Continental Choice Sdn Bhd & Anor v Ketua Pengarah Hasil Dalam Negeri (2021) MSTC 30-453, where it was stated that the purposive approach in interpreting a statute including the tax statute was only applicable if the statute was ambiguous and the purpose approach taken did not cause any injustice or absurdity.

In this case, the CoA found that Rule 3 of the 1999 Rules was unambiguous and ought to be given its literal and ordinary meaning. Under the said Rule, the taxpayer is required to be a company engaged in agriculture, resident in Malaysia and exporting agricultural produce to be entitled to the IEA. The phrase "engaged in agriculture" clearly showed that it required direct involvement in the planting or growing of the fresh flowers, and the mere activity of buying flowers from contract flower growers was not an activity within the meaning of the phrase.

Whether the taxpayer's factory is an industrial building within the meaning of Paragraph 63 of Schedule 3 of the ITA

The CoA affirmed the decisions by the SCIT and HC and held that the taxpayer's factory could be categorized as an industrial building, as the building was used for business purposes and to house machinery or plant for the subjection of goods to a process.

The CoA dismissed the IRB's argument that the taxpayer's factory was used only to package fresh flowers for export purposes, as there were also other activities / processes (e.g., inspecting, trimming, grading, bunching, cutting, hydrating, packaging etc.) undertaken in the factory.

Whether the HC had correctly held that the DGIR had no legal or factual basis to impose the penalty under Section 113(2) of the ITA

The CoA disagreed with the HC's position and held that the DGIR had rightfully exercised its discretion to impose a penalty under Section 113(2) of the ITA.

Under Section 113(2) of the ITA, the DGIR is given the discretion to impose a penalty equal to the amount of tax to any person who made an incorrect return or gave incorrect information in its tax return. In this case, the taxpayer had indeed provided incorrect information and failed to declare its income correctly, and the DGIR had only imposed a penalty of 45% of the tax undercharged (instead of the 100% allowable under the law). The CoA was also of the view that the defense of "good faith" (per Section 113(1) of the ITA) had no application with regard to the imposition of penalty under Section 113(2) of the ITA.

Overseas developments

Denmark introduces new filing requirements for transfer pricing documentation

Denmark recently introduced a requirement to pro-actively submit transfer pricing documentation (TPD) annually to the Danish tax authorities. Failure to submit within the applicable deadline will likely result in automatic financial penalties. Most companies within scope will need to submit their financial year (FY) 2021 TPD by 29 August 2022.

Summary of Legislation

For the financial years starting on or after 1 January 2021, the new legislation requires TPD to be submitted annually. The deadline for submitting compliant documentation is 60 days after the due date for the filing of the annual corporate income tax return. Therefore, for the financial year ended on 31 December 2021, the deadline for submission of FY21 TPD is 29 August 2022.

Under the new rules, taxpayers subject to TPD requirements are obliged to submit both the entity-specific local file and group-wide master file (including appendices as applicable) annually. However, it is recognized that in certain situations multinational groups are not able to finalize the master file in time to meet the deadline. Therefore, it is possible to request for an extension of the master file submission deadline and/or to use the master file prepared for the previous financial year as a temporary document if certain requirements are met.

Entities in scope

The TPD requirement applies to all Danish entities and permanent establishments of Groups which (measured on a global Group consolidated level) meet one of the following two thresholds:

- Have more than 250 employees
- Have more than DKK125 million in assets and more than DKK250 million in revenue

If one of the above criteria is met when measured on a Group-consolidated basis, then the Danish entity (or permanent establishment) falls within scope of these rules.

Potential penalties for non-compliance

As a starting point, the penalty for non-compliance is DKK250,000 (approx. €33,500) per legal entity, per year. It is anticipated that this penalty will be imposed automatically on the entities that do not meet the deadline for the pro-active submission of the TPD. Additionally, a penalty of 10% may be imposed on a potential income adjustment.

It is not clear at this stage what will be the practicalities associated with the submissions of the relevant documents.

European Commission proposes a Directive to tackle debt-equity bias in taxation

On 11 May 2022, the European Commission (the Commission) published a legislative proposal on the Debt-equity bias reduction allowance (DEBRA) initiative. The proposal sets forth rules to address the tax-related asymmetry in the treatment of debt and equity, with the aim to encourage companies to finance their investment through equity contributions rather than through debt financing (the draft Directive or DEBRA). This initiative was announced by the Commission in its Communication on Business Taxation for the 21st century published in May 2021.

The draft Directive applies to all taxpayers that are subject to corporate income tax in one or more European Union (EU) Member States, with the exception of financial undertakings. It includes two separate measures that apply independently: (i) a notional interest allowance on changes in equity levels; and (ii) a limitation on interest deduction to 85% of the exceeding borrowing costs (i.e., interest paid minus interest received). The proposal requires Member States to provide specific data to the Commission on an annual basis in order to allow monitoring of the implementation and effects of the new rules. The proposal also includes anti-abuse provisions to prevent tax-driven changes in equity levels.

The draft Directive will now move to the negotiation phase among Member States with the aim of reaching a final agreement. In the EU, adoption of tax legislation requires unanimity between all 27 Member States. The Commission proposes that the Member States shall transpose the Directive into their national laws by 31 December 2023 for the rules to come into effect as of 1 January 2024.

Detailed discussion

Background

On 18 May 2021, the Commission published the Communication on Business Taxation for the 21st Century (the Communication) that sets out the Commission's short-term and long-term vision to provide a fair and sustainable EU business tax system and support the recovery. Among the corporate tax reforms proposed in the Communication, the Commission announced its plans to table a legislative proposal in Q1 2022 setting out EU rules to "address the debt-equity bias in corporate taxation, via an allowance system for equity financing, thus contributing to the re-equitization of financially vulnerable companies."

Following that, on 1 July 2021, the Commission launched a public consultation on such proposal consisting of a questionnaire and the opportunity to submit a position paper. The consultation closed on 7 October 2021 with a total of 67 replies.

On 11 May 2022, the Commission published the draft DEBRA proposal that includes two separate measures that apply independently: (i) a notional interest allowance on changes in the levels of equity; and (ii) a limitation on interest deduction to 85% of exceeding borrowing costs (i.e., interest paid minus interest received).

According to the explanatory memorandum to the draft Directive, the proposal complements a number of other policy initiatives promoted by the Commission in parallel, including a proposal for Business in Europe: Framework for Income Taxation (BEFIT), which is expected to be published in 2023.

The draft Directive

Scope

The proposed rules would apply to all undertakings in the EU that are subject to corporate income tax in one or more Member States. Financial undertakings are excluded from the scope of this Directive as some are subject to regulatory equity requirements already preventing under-equitization. In addition, the Commission asserts that many are unaffected by interest limitation deduction rules. According to the Commission, if the proposed rules to address the tax related debt-equity bias were to apply to them, the economic burden of the measures would be unequally distributed at the expense of non-financial undertakings.

Allowance on equity

The proposed allowance on equity would be computed based on the difference between net equity at the end of the current tax year and net equity at the end of the previous tax year, multiplied by a notional interest rate. The notional interest rate is the 10-year risk-free interest rate for the relevant currency, and increased by a risk premium of 1% or, in the case of Small and Medium Enterprises (SMEs), a risk premium of 1.5%. If the difference between the above-mentioned equity levels is a negative amount (loss), then the computation will lead to a positive amount being added to the taxable income of the company unless the taxpayer provides sufficient evidence that this is due to accounting losses incurred during the tax period or due to a legal obligation to reduce capital.

To prevent tax abuse, the deductibility of the allowance is limited to a maximum of 30% of the taxpayer's EBITDA (earnings before interest, tax, depreciation and amortization) for each tax year. If the allowance on equity is higher than the taxpayer's net taxable income, the taxpayer may carry forward the excess of allowance on equity without a time limitation. In addition, taxpayers will be able to carry forward their unused allowance on equity which exceeds the 30% of taxable income, for a maximum of five tax years.

The Directive includes a number of anti-abuse measures to ensure that the rules on the deductibility of an allowance on equity are not used for unintended purposes:

- A first measure would exclude from the base of the allowance equity increases that originate from: (i) intra-group loans; (ii) intra-group transfers of participations or existing business activities; and (iii) cash contributions under certain conditions.
- Another measure sets out specific conditions for taking into account equity increases originating from contributions in kind or investments in assets.
- A third measure targets the re-categorization of old capital as new capital, which would qualify as an equity increase for the purpose of the allowance. Such re-categorization could be achieved through a liquidation and the creation of start-ups.

Limitation to interest deduction

The allowance on equity is accompanied by a limitation to the tax deductibility of debt-related interest payments. The aim is to better mitigate the debt-equity bias. Accordingly, the Directive proposes the introduction of a limitation on the deductibility of interest to 85% of exceeding borrowing costs (i.e., interest paid minus interest received).

Given that interest limitation rules already apply in the EU under Article 4 of the anti-tax avoidance Directive (ATAD), the Directive provides that the taxpayer will apply the rule under this proposal as a first step and then, calculate the limitation applicable in accordance with Article 4 of ATAD. If the result of applying the ATAD rule is a lower deductible amount, the taxpayer will be entitled to carry forward or back the difference in accordance with Article 4 of ATAD. This article of the ATAD, adopted on 12 July 2016 at the EU level, has been broadly implemented by Member States.

Monitoring and reporting

Member States will have to provide specific data to the Commission on an annual basis in order to allow monitoring of the implementation and effects of the new rules by the Commission. According to the Directive, each Member State will need to report within three months from the end of every tax period:

(i) The number of taxpayers that have benefited from the allowance on equity in the tax period
(ii) The number of SMEs that have benefitted from the allowance in the tax period
(iii) The total amount of expenditure incurred or tax revenue lost due to the deduction of allowance on equity allocated to the allowance on equity as compared to the national gross domestic product of the Member State
(iv) The total amount of exceeding borrowing costs
(v) The total amount of non-deductible exceeding borrowing costs
(vi) The number of taxpayers to which anti-abuse measures have been applied in the tax period including the related tax consequences and sanctions applied
(vii) The data on the evolution in the Member State of the debt/equity ratio.

Next steps

Article 115 of the Treaty on the Functioning of the European Union is the legal basis for the draft Directive. Proposals put forward under this special legislative procedure are subject to the Council's unanimity, while the European Parliament only has an advisory role. The next step will therefore be for the proposal to be discussed by the 27 EU Member States.

As with previous Directives with respect to direct taxation, it is expected that many changes will be made to the proposal during the negotiation process. Consequently, the final Directive, if adopted at all, could differ significantly from the current proposal. Once unanimity is achieved, the next step would be the publication of the Directive in the *Official Journal of the European Union*. The Commission proposes that the Member States shall bring into force the laws, regulations, and administrative provisions necessary to comply with the provisions of the final Directive by 31 December 2023 and that they shall apply these provisions from 1 January 2024.

Implications

Adoption of the proposed Directive would mark a significant step towards addressing the tax-induced debt-equity bias across the single market in a coordinated way. Currently, only six Member States address the debt-equity bias from a tax perspective and the relevant national measures differ significantly. While the notional interest allowance on equity would create benefits for business, the proposal is accompanied by a proposal to significantly limit the deductibility of interest, which may have a relevant negative impact.

While it is not yet known whether Member States will embrace the Commission's initiative, it is recommended that businesses and investors closely monitor the adoption process for any changes or clarifications to the proposal. Businesses that are in scope should carry out an initial analysis on their corporate structures based on the current draft. After all, individual Member States may opt to introduce the rules proposed in the draft Directive unilaterally if the 27 Member States fail to adopt the rules unanimously.

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Important dates

31 May 2022	6th month revision of tax estimates for companies with November year-end
31 May 2022	9th month revision of tax estimates for companies with August year-end
31 May 2022	Special 11th month revision of tax estimates for YA 2022, for companies with June 2022 year-end
31 May 2022	Statutory deadline for filing of 2021 tax returns for companies with October year-end. A blanket extension of time has been provided until 30 June 2022.
31 May 2022	Extended 2021 tax return filing deadline for companies with September year-end.
15 June 2022	Due date for monthly instalments
30 June 2022	6th month revision of tax estimates for companies with December year-end
30 June 2022	9th month revision of tax estimates for companies with September year-end
30 June 2022	Special 11th month revision of tax estimates for YA 2022, for companies with July 2022 year-end
30 June 2022	Statutory deadline for filing of 2021 tax returns for companies with November year-end. A blanket extension of time has been provided until 31 July 2022.
30 June 2022	Extended 2021 tax return filing deadline for companies with October year-end.

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