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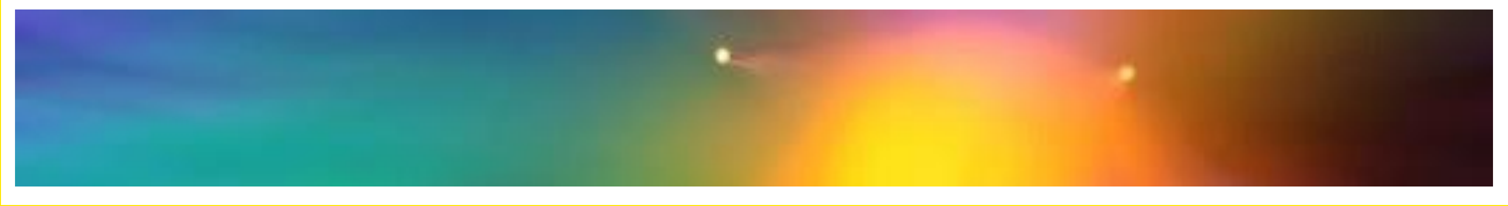
Malaysian developments

Income tax exemption on gains or profits derived, in lieu of interest, from *Sukuk Prihatin*

Under the Short-term Economic Recovery Plan (PENJANA) unveiled on 5 June 2020, the Government announced that the *Sukuk Prihatin* would be issued in the third quarter of 2020 (see *Take 5: COVID-19: Short-term Economic Recovery Plan*). The *Sukuk* will be utilized for specific programs, e.g. to improve internet connectivity to schools, fund micro enterprises and for research grants for infectious diseases.

Following the above, the Income Tax (Exemption) (No. 2) Order 2021 [P.U.(A) 95] was gazetted on 4 March 2021. The Order provides that a qualifying person resident in Malaysia is exempted from the payment of income tax for each year of assessment (YA) on the gains or profits derived, in lieu of interest, from *Sukuk Prihatin*[Note].

Note:
Sukuk Prihatin refers to the Islamic securities with a nominal value of up to RM666,417,500 issued by the Government in accordance with the principle of *Murabahah* on 22 September 2020.



The following terms have been defined in the Order:

(a) Qualifying person

- (i) An individual who is a Malaysian citizen aged 18 years and above
- (ii) A body corporate incorporated under the laws of Malaysia, but excludes a financial institution (FI) and a holder of a Capital Markets Services Licence carrying on the business of fund management under the Capital Markets and Services Act 2007 (CMSA), or
- (iii) A body of persons, partnership or limited liability partnership registered under any written law in Malaysia and carries on its business in Malaysia, but excludes a trustee registered as a member of the Association of Trust Companies Malaysia who acts on behalf of the person

(b) Financial institution

- (i) A bank, investment bank or insurer licensed or deemed licensed under the Financial Services Act 2013 (FSA)
- (ii) An Islamic bank, takaful operator or international takaful operator licensed or deemed licensed under the Islamic FSA
- (iii) A development FI prescribed under the Development Financial Institutions Act 2002, or
- (iv) An entity listed under Part 1, Schedule 4 to the CMSA

The Order stipulates that the exemption granted does not absolve the person from any requirement to submit any return, statement of accounts or any other information, as required under the Income Tax Act 1967.

The Order is deemed to be effective from YA 2020.

Extension of time for submission of tax returns under the Labuan Business Activity Tax Act 1990 (LBATA) for YA 2021

The Inland Revenue Board (IRB) has issued a letter dated 11 March 2021 to the Association of Labuan Trust Companies (ALTC) to confirm that Labuan entities would be granted an automatic extension of time until 31 August 2021 to submit their tax returns for YA 2021 (based on the financial year ended in 2020). The extension will only apply to Labuan entities which are up to date with their tax filings (i.e. until YA 2020) and payments.

The letter also clarifies the following:

- Where a company's "net profit / loss before tax" amount in its audited financial statement (FS) is denominated in a currency other than Ringgit Malaysia (RM), the exchange rate published by the Accountant General Department of Malaysia is to be used to compute the amount in RM for the purpose of completing Column A12 (i.e. net profit column) of the LE1 Form (i.e. Return of Profits by a Labuan entity under Section 5 and Subsection 2B(1A) of the LBATA).

- A Labuan entity which is dormant is still required to file a LE1 Form together with a formal notification letter and audited accounts or FS. Where the audited accounts or FS are not prepared, management accounts are also acceptable.

- The definition of a "dormant Labuan entity" – please see the Appendix to this tax alert for the definition provided in Appendix 1 of the IRB's letter dated 11 March 2021.

Frequently Asked Questions on tax deduction on costs for renovation and refurbishment of business premises

As highlighted in earlier tax alerts, it was proposed that a tax deduction of up to RM300,000 be given on costs for renovating and refurbishing business premises, where such costs are incurred between 1 March 2020 and 31 December 2021 (see *EY Take 5: Economic Stimulus Package 2020* and *EY Take 5: COVID-19: Short-term Economic Recovery Plan*). To legislate the proposal, the Income Tax (Costs of Renovation and Refurbishment of Business Premise) Rules 2020 [P.U.(A) 381] were gazetted on 28 December 2020 (see *Tax Alert No. 1/2021*).

Following the above, the IRB has published a Frequently Asked Questions (FAQs) document in Bahasa Malaysia, titled "Soalan Lazim Potongan Cukai Bagi Kos Pengubahsuaian Dan Pembaharuan (R&R) Premis Perniagaan Di Bawah P.U.(A) 381/2020" dated 11 March 2021, to provide clarification on the Rules.

Some of the key points are outlined below.

- The FAQs clarify that all business premises, regardless of whether they are owned or rented by the taxpayer, would qualify for the deduction. This is on condition that the taxpayer claiming the deduction uses the premises for the purpose of his business.

- The Rules stipulate that to be eligible for the tax deduction, the costs of renovation and refurbishment of the business premises must be certified by an external auditor.

  The FAQs clarify that an "external auditor" refers to a certified auditor who is able to verify the said cost and issue a specific certification (in any format deemed suitable) upon verification.

  The FAQs further stipulate that the fees incurred for the external auditor are not to be included as part of the "cost for renovation and refurbishment of business premises" and will not be allowed a tax deduction.

- The FAQs clarify that in instances where the total cost of renovating and refurbishing the business premises exceeds RM300,000, the taxpayer would still be able to claim a tax deduction of up to RM300,000 (i.e. the taxpayer will not forfeit the entire claim by virtue of incurring an amount exceeding RM300,000).

- Taxpayers claiming the tax deduction are required to retain the following supporting documents, to be produced in the event of an audit:
  - Business registration certificate
  - Proof of ownership of the business premises or valid tenancy agreement (whichever applicable)
  - Invoices for the renovation and refurbishment costs
  - Certification of the said costs by an external certified auditor

Overseas developments

India's reduced threshold for e-invoicing applies from 1 April 2021

India's Central Board of Indirect Taxes and Customs (CBIC) has recently issued a Notification on the reduction of the turnover threshold for e-invoicing for Goods and Services Tax (GST).

With effect from 1 April 2021, e-invoicing will be mandatory for all taxpayers that have an aggregate turnover exceeding INR500 million (approximately US$6.85 million) in any preceding financial year from 2017-18 onwards.

Earlier, the said threshold was reduced from INR5 billion to INR1 billion with effect from 1 January 2021.

With the implementation date for the reduced turnover threshold for e-invoicing approaching soon, businesses may need to revise their processes and IT systems to ensure compliance.

Indian Supreme Court rules on taxability of software payments

On 2 March 2021, the Indian Supreme Court ruled in favor of non-Indian taxpayers with computer software sales to Indian customers. The Court ruled that software sales should not be characterized as "royalties" under applicable tax treaties, consequently not triggering Indian withholding tax in the absence of a permanent establishment (subject to the entity's tax treaty eligibility).

The Supreme Court ruling and implications for taxpayers are summarized below.

Detailed discussion

Background

The taxation of income from the sale of computer software in cross-border transactions has been a contentious issue in India for many years, with the key question being whether such income should be characterized as royalty (triggering an Indian withholding tax) or as business income (triggering no Indian tax in the absence of a permanent establishment).

While the Indian domestic tax laws provide a very broad definition of royalties (covering payments for the transfer of all or any rights for the use of or right to use computer software), various tax treaties limit the definition of royalties to payments for the use of, or the right to use, any copyright of a literary, artistic or scientific work.

Indian tax authorities have generally taken the position that income arising from transactions involving the sale of software programs or licenses should be characterized as royalty, irrespective of the nature of the rights acquired by the end-user or the reseller. However, taxpayers have often taken the position that the characterization under the applicable tax treaty should be based on the nature and extent of rights granted to the end-user. Divergent views of the Indian judicial authorities over the course of two decades have resulted in the progression of the issue to the Supreme Court.

Supreme Court ruling

The Supreme Court ruling covered the following categories of software payments:

- Sales of software directly to an end-user by a non-resident
- Sales of software by a non-resident to Indian distributors for resale to customers in India
- Sales of software by a non-resident to a foreign distributor for resale to customers in India
- Software bundled with hardware and sold by foreign suppliers to Indian distributors or end-users

The following considerations were provided in the Supreme Court's decision.

- An end-user who obtains a non-exclusive, non-transferable and restricted right to a copy of the software makes payment for the copyrighted software and not for the use of the "copyright" of the owner. Similarly, where the end-user does not obtain any rights to the copyright under the license agreement, making a copy of the software for internal use (as permitted by the license) does not involve the grant of a right to the copyright. The Supreme Court concurred with the view that payments made by end-users and distributors are akin to payments for the sale of goods and not for

the grant of a license to the copyright under the *Indian Copyright Act 1957* (ICA).

- The designation given to a transaction is not a decisive factor, and the true effect of the agreement needs to be considered, taking into account the overall terms of the agreement and the relevant circumstances.
- Prior to the expansion of the royalty definition under the domestic tax law in 2012 to specifically include software payments, an amount could only be treated as royalty if there was a transfer of all or any rights in a copyright by way of a license or other similar arrangements. If there was a payment for the grant of a license, such payment would constitute royalty only if such license results in the transfer of the rights in the copyright under the ICA. As the licenses granted to the distributors and the end-users did not involve the grant of any rights to the copyright, the payments made for such licenses cannot be considered as royalties under both the domestic tax law (prior to 2012) and the tax treaties.
- The 2012 expansion of the scope of the royalty definition in the domestic tax laws, which was intended to have retrospective application, could not oblige withholding agents to apply withholding tax on a retrospective basis.
- If the tax treaty provisions are aligned with the Organisation for Economic Co-operation and Development Model Convention (OECD MC), such provisions may be interpreted using the OECD MC Commentary. India's position on the OECD MC Commentary would not be considered a decisive factor for the interpretation of tax treaties, particularly when such positions are not stated in explicit language and are also not reflected in subsequent tax treaties concluded by India. The OECD Commentary supports the position that payment to make a copy or an adaptation of a computer program to enable the use of the software for which it was supplied does not constitute royalty. This also supports the position that the payments made by distributors and end-users should not constitute royalties.
- The Supreme Court reiterated its earlier ruling which confirms that a withholding agent is only required to withhold tax if the amount is chargeable to tax under both the domestic tax law and the tax treaty. The Supreme Court confirmed that the determination of the income of a non-resident chargeable to tax in India is subject to the provisions of the relevant tax treaty. If an item of income is not chargeable to tax under the tax treaty, then such income could not be chargeable to tax under the domestic tax law.

Implications

The taxation of cross-border payments for the use of computer software has been a contentious issue in India for many years. This Supreme Court decision was much awaited to settle the controversy and to provide certainty on the issue.

The decision of the Supreme Court is binding on all Indian tax authorities and subordinate courts in India and will apply to all pending litigation and audits. Taxpayers who have disputes pending with Indian tax authorities or subordinate courts involving similar issues could resolve these cases by seeking to apply the Supreme Court ruling. In addition, taxpayers in certain cases could seek refunds of any withholding taxes that may have been deducted on past sales income from Indian customers.

This Supreme Court ruling highlights the significance of entitlement to tax treaty benefits given that these transactions may continue to trigger Indian withholding tax under the domestic tax law. Tax treaty benefits are subject to broad conditions, including the selling entity being the beneficial owner of the income, holding a Tax Residency Certificate and also complying with applicable anti-avoidance provisions, including those introduced pursuant to the OECD Multilateral Instrument (MLI).

In addition, applicable from 1 April 2020, non-residents will need to evaluate the impact of the E-Commerce Supply or Services Equalisation Levy

(including the expanded scope proposed under Budget 2021) and its interplay with the ruling.

Definition of "dormant Labuan entity" per the IRB's letter dated 11 March 2021

1. A Labuan entity is considered dormant if it:
   a. Has never commenced operations since the date of its incorporation
   b. Has previously been in operation or carried on business but has now ceased operations or business
   c. Does not have any significant accounting transaction for one financial year before the occurrence of substantial change (i.e. 50% or more) in its equity shareholding. This means that there is no recording entry in the company's accounts other than the minimum expense for compliance with stipulated statutory requirements. The minimum expenses referred to are as follows:
      (i) Filing of the company's annual return to the Companies Commission of Malaysia or Labuan Financial Services Authority
      (ii) Secretarial fee for filing of company's annual return
      (iii) Tax filing fee
      (iv) Audit fee, and
      (v) Accounting fee

2. A Labuan entity is not considered dormant if it owns shares, real properties, fixed deposits and other similar investments including income such as rent, interest etc. (if any) received by virtue of the mentioned ownership.

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Important dates

31 March 2021	6th month revision of tax estimates for companies with September year-end
31 March 2021	9th month revision of tax estimates for companies with June year-end
31 March 2021	Statutory deadline for filing of 2020 tax returns for companies with August year-end
15 April 2021	Due date for monthly instalments
30 April 2021	6th month revision of tax estimates for companies with October year-end
30 April 2021	9th month revision of tax estimates for companies with July year-end
30 April 2021	Statutory deadline for filing of 2020 tax returns for companies with September year-end

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