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Malaysian developments

Tax incentive for manufacturers of pharmaceutical products

In Budget 2021, to encourage manufacturers of pharmaceutical products (including vaccines) to invest in Malaysia, the following preferential corporate income tax rates were proposed (see *Take 5: Malaysia Budget 2021*):

- 0% to 10% tax rate for the first 10 years
- 10% tax rate for the next 10 years

Thereafter, the Malaysian Investment Development Authority (MIDA) published on its website the "Guidelines for Incentive for Manufacturers of Pharmaceutical Products Including Vaccines Under the 2021 Budget" (Guidelines) dated 27 August 2021 to provide further details on the incentive, e.g., the eligibility criteria and application process (see *Tax Alert No. 20/2021*). The Guidelines also stipulated that the incentive will be legislated by way of subsidiary legislation under the Income Tax Act 1967 (ITA), to be read together with Section 65B of the ITA.

Following the above, to legislate the proposals, the Income Tax (the Incentive for Manufacturers of Pharmaceutical Products Scheme) Rules 2022 [P.U.(A) 34] were gazetted on 17 February 2022. The Rules provide that a qualifying company which carries on a business in respect of a qualifying activity under the Incentive for Manufacturers of Pharmaceutical Products Scheme (Scheme) shall be taxed at the following rates:

- 0% to 10% tax rate for the first 10 years
- 10% tax rate for the next 10 years

The incentive will commence from the date as determined by the Minister.

A "qualifying company" is a manufacturer of pharmaceutical products whose application for the Manufacturers of Pharmaceutical Products Incentive Scheme has been approved by the Minister. The application must be received by the Minister, through MIDA, between 1 January 2021 and 31 December 2022.

To be eligible for the incentive, a qualifying company approved under the Scheme is required to:

- Incur its first qualifying capital expenditure (excluding land) within one year from the date the approval letter is issued
- Incur the full amount of the qualifying capital expenditure as specified in the approval letter within five years from the date the first qualifying capital expenditure was incurred
- Comply with the conditions outlined in the Schedule of the Rules (refer to the Appendix to this Alert) and any other conditions imposed by the Minister as specified in the approval letter and Guidelines issued or revised by MIDA and approved by the Minister

The following terms have been defined in the Rules:

(a) Manufacturer of pharmaceutical products

A company which:

- Is a Malaysian-resident and incorporated under the Companies Act 2016
- Possesses a manufacturing license (ML) under the Industrial Co-ordination Act 1975 from the Minister of International Trade & Industry (MITI), or a confirmation letter from MIDA providing an exemption from ML requirements
- Manufactures pharmaceutical products including formulation in Malaysia (excluding fill and finish activities)

(b) Fill and finish activity

The process of filling vials with vaccine and finishing the process of packaging the medicine for distribution

(c) Qualifying activity

Activity prescribed by the Minister as specified in the Guidelines issued and/or as revised by MIDA and approved by the Minister

The Rules also provide that the Minister may allow the qualifying company to surrender the incentive granted, by providing notice in writing to the Minister through MIDA, except in situations where the qualifying company fails to comply with any conditions imposed in relation to the incentive. The surrender of the incentive shall take effect from the first day in the basis period for the year of assessment (YA) in which the application for the surrender of the incentive is received by the Minister through MIDA.

The Rules are effective from YA 2021.

Update on the amendments to the definitions of a "Research and Development (R&D) company" and a "Contract R&D company" under the Promotion of Investments Act 1986 (PIA)

Pursuant to the Finance Act 2021, with effect from 1 January 2022, an "R&D company" or a "Contract R&D company" under the PIA will be required to apply for and obtain approval from MITI to qualify as a company approved as an 'R&D status company'. The approval, if granted, will be for a period of five years, and is extendable for a further five years (subject to approval).

Under the savings and transitional rules, a grace period of six months (i.e., from 1 January 2022 to 30 June 2022) is given to existing R&D companies and Contract R&D companies. If the companies intend to retain their R&D status after the grace period, they are required to notify the Minister of such intention within the grace period, for the Minister's consideration.

Following the above, MIDA issued a media release on 3 February 2022 to state that the notification by the existing R&D companies and Contract R&D companies are to be submitted to MIDA for consideration. For this purpose, the companies are required to provide documents to prove that they are undertaking activities related to R&D (as defined under the PIA) and have complied with conditions imposed previously in their approval letters.

Note:
We understand that submissions may be made via MIDA's online application platform at the following link:
https://investmalaysia.mida.gov.my/EIP/InvestMalaysia.aspx

Overseas developments

OECD releases Pillar One public consultation document on draft tax base determinations rules

On 18 February 2022, the Secretariat of the Organisation for Economic Co-operation and Development (OECD) released a public consultation document (Document) with draft model rules (Rules) on tax base determinations under Amount A in connection with Pillar One of the OECD/G20 project on Addressing the Tax Challenges Arising from the Digitalisation of the Economy (the so-called BEPS 2.0 project).

The Rules are intended to establish the profit (or loss) of an in-scope multinational enterprise that will be used for Amount A calculation purposes (i.e., the tax base). Under the Rules, the Adjusted Profit Before Tax (i.e., the tax base) is the Financial Accounting Profit (or Loss) of the Covered Group after making the relevant book-to-tax adjustments[Note 1], eligible restatement adjustments, and deducting any net losses[Note 2].

Note 1:
The following income and/or expenses included in the computation of the Financial Accounting Profit (or Loss) of the Period will be reversed:
(a) Tax expense (or tax income)
(b) Dividends
(c) Equity gain (or loss)
(d) Policy disallowed expenses

*Practical application of the above will be elaborated in Commentaries to be issued in due course

Note 2:
(a) Net losses for a period constitute the total amount of cumulative Financial Accounting Losses that exceed the total amount of cumulative Financial Accounting Profits of the Covered Group over the

Eligible Prior Period(s), after making the relevant adjustments for each Eligible Prior Period

(b) Where an Eligible Business Combination or an Eligible Division occurred, and if the Business Continuity Conditions are met, the related Transferred Losses, if any, are added to the net losses of the Covered Group

The Document also contains the relevant definitions that are referenced in the Rules, for further clarity.

The Rules reiterate that the profit (or loss) of a Covered Group will be based on consolidated group financial accounts. Covered Groups are also required to calculate their profits using Qualifying Financial Accounting Standards (i.e., IFRS and Equivalent Financial Accounting Standards).

However, it is noted that the Rules do not include the tax base rules that are necessary for Covered Groups that are subject to segmentation for Amount A purposes. The relevant rules will be released at a later date.

As the application of the Rules would have significant implications for companies that are in scope of Pillar One Amount A, the release of this Document is an opportunity for companies to provide input on the practical effects of the Rules. Comments on the Document are to be submitted by **4 March 2022**.

In addition, as a series of consultation documents is expected to be released by the OECD in the coming months, companies that could be in scope of Pillar One Amount A should also monitor the developments closely.

India releases Union Budget 2022

The Finance Minister of India presented the Union Budget 2022 (the Budget) on 1 February 2022. The Budget includes positive proposals such as the extension of deadlines to commence manufacturing for new companies electing a concessional tax rate regime, the extension of deadlines for the incorporation of start-ups claiming tax holiday benefits, the reduction of the peak surcharge rate for long-term capital gains, and the ability to file updated tax returns with extended deadlines.

The key budget proposals are summarized below.

Detailed discussion

Corporate tax rates

- The corporate tax rates (including Minimum Alternate Tax (MAT) rates) for Indian companies and partnerships (including Limited Liability Partnerships) are proposed to remain unchanged.

Key tax proposals

- The deadline for the commencement of manufacturing or production by new manufacturing companies electing the lower corporate tax rate of 15% is proposed to be extended by one year, i.e., from 31 March 2023 to 31 March 2024.

- The deadline for the incorporation of start-ups claiming tax holiday benefits is proposed to be extended by one year, i.e., from 31 March 2022 to 31 March 2023.

- The surcharge on long-term capital gains is proposed to be capped at 15% for individuals and certain non-corporate entities (such as the Association of Persons) for all capital assets. The current rate is graded and goes up to 37%.

- The Budget proposes to grant the following additional exemptions:
  - For non-residents dealing with International Financial Service Center (IFSC) units:
    - Income from the transfer of offshore derivative instruments or over-the-counter derivatives entered into with an offshore banking unit set-up in an IFSC.
    - Royalty or interest income received from a unit set up in an IFSC on the lease of ships (in addition to the existing exemption on the lease of aircraft).
    - Income of a non-resident from a portfolio of securities, financial products or funds maintained with the offshore banking unit set up in an IFSC, subject to conditions.
  - For IFSC units:
    - Premium on the issue of shares to a specified fund set up in an IFSC, in excess of the fair value of such shares.
    - Gains from the transfer of a ship leased by a unit set up in an IFSC.

- The Budget proposes to withdraw the lower tax rate of 15% (plus surcharge and cess) on the dividend income received by an Indian company from a specified foreign company (i.e., such dividend income is proposed to be taxed at regular tax rates).

- The Budget proposes to allow taxpayers to file an updated tax return within three years from the end of the tax year, subject to payment of additional taxes (i.e., 25% of the tax and interest due on the additional income reported, if the updated return is filed within two years from the tax year; or 50% of such tax and interest, if the updated return is filed after two years but before three years from the tax year). However, in certain specified circumstance, such an updated tax return cannot be filed. Such circumstances include an update resulting in a refund of tax, situations where the tax authorities have already commenced audit proceedings, etc.

- The Budget proposes the following clarificatory amendments:
  - Expenditures relating to earning exempt income will not be tax deductible even if the exempt income is not earned during the tax year.
  - Health and education cess levied on income tax will not be tax deductible as a business expenditure with effect from the tax year 2004-2005.

- In cases of business reorganizations, the Budget proposes to permit successors of the business to file a modified tax return for the period between the effective date of the business reorganization and the date of the order of the approving authority.

- A new regime has been proposed to tax the transfer of virtual digital assets (VDA) such as cryptocurrency and non-fungible tokens at the rate of 30% (plus applicable surcharge and cess) with effect from 1 April 2022. Withholding tax at 1% (with effect from 1 July 2022) and gift tax provisions on VDA are also proposed.

- The Budget proposes the introduction of dividend stripping and bonus stripping provisions for units of Infrastructure Investment Trust (InvIT), Real Estate Investment Trust (REIT), Alternative Investment Fund (AIF) and the extension of bonus stripping provisions to other securities (including stocks and shares).

Indian Government releases restrictive interpretation of Most Favored Nation clause

On 3 February 2022, the Indian Government issued a Circular clarifying the applicability of the Most Favored Nation (MFN) clause found in some of India's Double Taxation Avoidance Agreements (DTAAs). The Circular restricts the applicability of the MFN clause in

a DTAA between India and another country (the second State) to cases where all the following conditions are satisfied:

- India's DTAA with the country which has a lower rate or restricted scope (the third State) is entered into after the signature/entry into force (depending on language of MFN Clause) of India's DTAA with the second State.
- The third State must be an OECD member at the time of signing its DTAA with India.
- India limits its taxing rights in relation to the rate or scope of taxation in its DTAA with the third State.
- India issues a separate notification under the Income Tax Law (ITL) for importing the favorable benefits of the DTAA with the third State into the DTAA with the second State.

The above Circular will not be applicable in the case of taxpayers who have received a favorable decision by any court on the applicability of the MFN clause.

The Circular and its implications for taxpayers are summarized below.

Detailed discussion

Background

India's DTAAs with certain countries have an MFN clause which provides that if, after the signature/entry into force of those DTAAs, India enters into a DTAA on a later date with another OECD member country which provides a beneficial rate or a restrictive scope of taxation on dividends, interest, royalties, etc., then a similar benefit should be accorded under the former DTAAs.

Illustratively, DTAAs signed subsequently by India with countries like Slovenia, Colombia and Lithuania provide for a lower withholding tax (WHT) rate of 5% on dividends, subject to certain conditions. However, these countries were not OECD members when their respective DTAAs with India were entered into but became OECD members only at a later date. There was a lack of judicial guidance on whether the beneficial WHT rate on dividends under the DTAAs with Slovenia, Lithuania and Colombia could be applied to other DTAAs which have an MFN clause. A Court ruling interpreted the MFN provisions in favor of the taxpayer, granting the benefit of the lower WHT rate. This ruling was subsequently followed by various other Indian Courts.

In addition, countries like the Netherlands and France published a unilateral decree/ notification which categorically provides that the benefit of the 5% dividend WHT rate as available in the DTAA with Slovenia shall be made applicable to the DTAA with the Netherlands and France. The Swiss competent authorities also released a similar statement on 13 August 2021.

Due to the lack of guidance in the Indian context, representations were filed before the Indian tax authorities seeking clarification on India's stand on the application of the MFN clause. In this context, the Indian Government issued the Circular clarifying its position.

Clarification provided in the Circular

The Circular clarifies India's position on the interpretation of the MFN clause present in the Protocol to India's DTAAs, especially with certain European states and OECD member countries, as follows:

- A plain reading of the MFN clause in the DTAA provides that the third State has to be a member of the OECD both at the time of conclusion of the respective DTAA with India as well as at the time of applicability of the MFN clause.
- Unilateral decrees, notifications, and clarifications given by the treaty partner(s) do not represent a shared understanding on the applicability of the MFN clause and have no binding effect on India as the same have been issued without any consultation with India.
- The concessional rate or restricted scope of taxation is to apply from the date of entry into

force of the DTAA with the third State and not from the date on which such third State becomes an OECD member.

- A notification under the provisions of the ITL is required to implement the provisions of a DTAA. India has not issued any notification importing the beneficial provisions from DTAAs with Slovenia, Lithuania and Colombia to the DTAAs with France, the Netherlands or Switzerland.
- Selective invocation and application of the MFN clause as reflected in the unilateral instruments of the Netherlands, France, and Switzerland are not permitted as per the rules of interpretation of international treaties. For example, the India-Lithuania DTAA provides for the beneficial WHT rate of 5% on dividend income only if the company receiving the dividends holds directly at least 10% of the capital of the company paying the dividends. However, in all other cases, the WHT rate prescribed is 15%. Import of only the concessional rate of 5% and not the 15% rate for other cases by invoking the MFN clause is not justified.

The Circular clarifies that the benefit of a lower rate and restricted scope under the MFN clause will be provided only when all the following conditions are satisfied cumulatively:

- India's DTAA with the third State is entered into after the signature/entry into force (depending on the language of the MFN clause) of India's DTAA with the second State.
- The third State has to be an OECD member at the time of signing its DTAA with India.
- India limits its taxing rights in relation to the rate or scope of taxation in its DTAA with the third State.
- India issues a separate notification under the ITL for importing the favorable benefits of the DTAA with the third State into the DTAA with the second state.

However, it is also clarified that the Circular will not be applicable to taxpayers that have received a favorable decision by any court on this issue.

Implications

The Circular clarifies India's position on the applicability of the MFN clause. This position is divergent from the legal positions upheld by Courts in India. For example, the Delhi High Court in separate rulings has held that: (i) the conditions for applicability of the MFN clause should be tested as of the date of the transaction rather than the date when the DTAA with the third State was entered into; and (ii) a generally accepted principle is that Protocol is an integral part of the DTAA and there is no need for a separate action for giving effect to the self-operational MFN clause provided in the DTAAs.

It is a well-accepted principle of interpretation that the Circular binds taxpayers only if it is favorable to taxpayers. Taxpayers intending to apply the MFN clause in the Indian context will need to evaluate the impact of the Circular, taking into account the applicable legal position and considering the risk and consequences of a short deduction or short payment of tax.

Conditions for a qualifying company under the Scheme

Condition	Requirement
Minimum number of full-time employees in Malaysia with a basic salary of at least RM5,000 per month	15% of total full-time employees
Minimum number of employees with a diploma or degree in science and technical fields	20% of total employees
Minimum number of full-time employees who are Malaysian citizens	80% of total employees
Minimum amount of annual operating expenditure in Malaysia (in Ringgit Malaysia) (to be complied with at the end of the last year of the specified YAs)	As specified in the approval letter
Number of trainees from local universities, polytechnics or industrial training placements at Technical and Vocational Education and Training institutions	At least six Malaysian trainees each year, with a minimum training period of three months
Value-added for the product	At least 40%
Corporate social responsibility (CSR) activities	Undertake CSR activities with at least one hospital or health institution in Malaysia recognized by the Ministry of Health Malaysia each year within the specified YAs

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Important dates

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

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