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The 1995 Malaysian budget significantly cuts corporate and individual taxation, and actively encourages vocational education and training, alongside increased research and development activity. Barry Wong of Arthur Andersen, Kuala Lumpur reports

The 1995 Malaysian Budget was presented to Parliament in late October 1995 against the background of a robust economy. Malaysia's master economic plan for 1991-1995 (the Sixth Malaysian Plan) increased economic growth at an average real GDP rate of over 8%, surpassing its target of 7%.

Maintaining sustainable economic growth is a primary objective of the 1995 Budget. Limiting inflationary pressure on the economy is the other main concern. Government intervention implementing anti-inflationary measures has brought the inflation rate under 4%.

The Budget proposed radical cuts to corporate and individual tax rates, and customs and excise duties on many goods. Comprehensive tax incentives for research and development are introduced for companies to invest in the local development of research, and to develop a technically competent labour force.

Capital-intensive projects involving high technology are given preferential treatment. Withholding taxes on interest, royalties and technical fees paid to non-residents will also be cut.

These measures are incentives to the corporate sector to help the government achieve industrialized status for the country by 2020.

Reduction in taxes

The government aims to make Malaysia a more conducive investment destination, especially for foreign investors, and to increase Malaysia's competitiveness in the global market. Therefore, the corporate tax rate will be cut from 32% to 30%, from the 1995 year of assessment. This means profits for the financial year ended in 1994 will be subject to the reduced rate.

With the reduction of the corporate tax rate to 30% and in the absence of value-added tax or goods and services tax, Malaysia's tax regime ranks competitively with other jurisdictions in the region (see table, page 12).

Personal tax rates have also been cut. The first M$2500 (US$1000) of taxable income is exempt from tax. The previous top tax rate of 32% on the first M$100,000 of taxable income is cut to 28%.

The marginal rate on taxable income of M$100,001 to M$150,000 is now 31%, a 1% reduction compared to the pre-1995 Budget tax rate. The top marginal rate remains 32%. This is imposed on taxable income exceeding M$150,000.

The tax burden of the low income group is further cut by giving a higher tax rebate to taxpayers with taxable income of M$10,000 or lower. Taxpayers are given a deduction of M$800 for the maintenance of each child under 18 years. Disabled taxpayers are also given increased personal deductions.

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Offshore income

A labour shortage and increased labour costs have prompted some Malaysian corporations to relocate labour-intensive facilities to emerging economies such as China and Vietnam. Other cash-rich companies equipped with locally-developed technology have also ventured overseas to countries such as Cambodia, Laos and eastern Europe.

Malaysia has a territorial system of taxation, except for certain businesses. Therefore, there is little incentive for investors to remit offshore profits to Malaysia.

The government encourages outbound investment in emerging economies and third world countries. However, it is keen to see offshore profits remitted to Malaysia and has over a period of time indicated that a partial exemption of offshore income will be given to such investors.

The Budget proposes to exempt resident companies from income tax on offshore income remitted to Malaysia, effective from the 1995 year of assessment. However, banking, insurance and shipping businesses which are taxed on income on a worldwide basis will not be entitled to this exemption.

Malaysian companies welcome this exemption, but are facing problems with distributing the offshore income remitted to Malaysia to their shareholders. Malaysia's imputation system dictates that dividends must be distributed out of taxed profits for the distributing company to avoid paying tax on the dividend distribution.

Clearly, offshore income which is exempt from tax cannot be distributed as dividends without facing a tax charge on the distribution of dividends out of the offshore income. It appears the tax authorities are addressing this issue and may provide rules to permit companies to pay a dividend out of offshore profits remitted to Malaysia.

Investors should note that, notwithstanding the exemption of offshore income from payment of Malaysian tax, there is no point in remitting the offshore profits to Malaysia if funds are required for other offshore activities. Multinationals should not unbundle their offshore structures without due consideration.

Operational headquarters incentive

The operational headquarters (OHQ) incentive was first introduced for the manufacturing sector in 1990 to promote Malaysia as an international centre for foreign multinationals. This incentive was later extended to include the provision of treasury and management services, and made available to the financial and professional sectors.

The OHQ incentive was extended to locally 'owned companies in the recent Budget. Thus, an OHQ can be owned by locally incorporated companies. In addition, fiscal and non-fiscal incentives will be provided to OHQs.

For a company to qualify as an OHQ, it must provide at least three of the following categories of services:

- management and administrative services;
- treasury and fund management services;
- other financial services;
- research and development; and
- training and personnel management.

Procurement of raw materials and finished products is considered as the provision of management and administrative services. The OHQ incentive is also available to the agricultural, construction and mining industries. The incentive is approved subject to other conditions such as the annual amount of business expenditure, the appointment of senior professional and management personnel etc.

The OHQ incentive is initially given for five years. The authorities can extend this for a further five years if the OHQ fulfils specific conditions stated at the time of approval.

With the abolition of income tax on offshore income remitted to Malaysia by resident companies from the 1995 year of assessment, dividend income received by all OHQs, including companies established before the OHQ incentive came into effect, are not now subject to income tax.

Instead, business income and locally sourced income, such as interest and royalties received from the OHQ's offshore offices and related companies, will now be subject to tax at a preferential 10% rate (compared to the normal 30% tax rate on Malaysia-sourced income). The chargeable income of the OHQ after the deduction of tax payable on the offshore income is available for distribution as tax-free dividends to its shareholders.

Asian corporate tax rates

Country	Tax rate (%)
Singapore	27
Brunei	30
Thailand	30
Indonesia	30*
Philippines	35
Vietnam	25 - 45**
Hong Kong	16.5
China	33*

*Top marginal tax rate, based on graduated rates of tax

** Depends on type of business

To enable an OHQ to transact in foreign currencies, exchange controls have been relaxed. An OHQ can borrow freely in foreign currency without approval from the Central Bank. Local borrowings up to M$10 million are also freely permitted. Several foreign currency accounts or one multi-currency account with designated banks in Malaysia can be operated by OHQs with minimal restrictions.

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Withholding taxes

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A major grievance of foreign investors doing business in Malaysia is the comprehensive coverage of its withholding taxes. Withholding tax is levied not only on interest and royalties payable to a non-resident, but also on offshore payments made by a resident to a non-resident for the provision of technical services, and for the use of movable equipment.

To compound the issue, the Malaysian tax authorities have notified local accounting bodies that withholding tax applies to technical fees payable to a resident in a country which has a tax treaty with Malaysia. Treaty protection under the business profit article will not apply even if the non-resident does not have a permanent establishment in Malaysia (the only exception is the Malaysia-Germany tax treaty which the Malaysian tax authorities concede exempts technical fees from Malaysian tax).

In line with the government's move towards lower direct taxes, withholding tax rates on interest, technical fees and royalties will be cut by 5% (see table, page 13).

The reduction in the withholding tax rate for interest will hopefully promote the inflow of foreign loans at a lower cost to finance local development projects. The reduced withholding tax rates for technical fees and royalties should accelerate technological progress, increase access to sophisticated technology and encourage the transfer of know-how to Malaysia.

Insurance industry

The Budget proposes significant changes to the taxation of life insurance businesses effective in the 1995 year of assessment.

Income of the life fund of an insurance business carried on in Malaysia by a resident or non-resident is now taxed at the corporate tax rate. The proposed amendment cuts the tax on the income and capital gains derived from the life fund to 8%.

As a trade off, capital gains from the realization of investments made from shareholder funds, and any actuarial surplus from the life fund and apportioned to shareholder funds, will be subject to tax at the 30% corporate rate.

Before this amendment, gains from the realization of investments made from shareholder funds were treated as capital in nature and so no tax arose on the gains.

In addition, deductions and tax depreciation are not allowed against the taxable income from the shareholders funds.

It is normal practice for insurance businesses to make an annual provision for claims incurred but not reported (IBNR), and make a deduction for tax purposes. The law permits the taxpayer to deduct 'claims admitted' and there is therefore some doubt whether IBNRs are strictly deductible.

The tax authorities had allowed taxpayers to claim the IBNRs, but have recently addressed the issue in depth. If they disallow the IBNRs, many insurance companies will be placed in financial difficulty.

From the 1995 year of assessment, IBNRs confirmed by the Central Bank will be deductible. This should avoid an adverse impact on the insurance industry, promote sound management practice and establish the true financial position of insurance companies.

It remains to be seen if the Malaysian tax authorities will reopen assessments of previous years to disallow the IBNRs claimed and permitted by the authorities.

From the 1995 year of assessment, annuities from life insurance policies will be exempt from tax. This should boost the life insurance industry and at the same time promote savings.

Withholding tax rates

	Interest	Technical fees	Royalties
Existing rate	20%	15%	15%
New reduced rate	15%	10%	10%

New investment incentive

Before the Budget, new incentives and rules for investments in less developed areas, capital intensive and high technology industries, research and development companies and the construction of infrastructural facilities were introduced to stimulate investment.

To disperse the expanding industrial base to other parts of Malaysia, new incentives were given for locating manufacturing facilities on the eastern corridor, which comprises the states of Kelantan, Terengganu, Pahang excluding certain industrial estates, and district of Mersing in Johore, Sabah and Sarawak.

The incentives are:

- an exemption from import duty on raw materials, components and parts used for a manufacturing process;
- a five year exemption of 85% of taxable income of a company engaged in a promoted activity or manufacturing a promoted product;
- an investment tax allowance which exempts from tax 80% of the capital expenditure incurred for each of five years approved for the investment, provided the allowance does not exceed 85% of the company's taxable income;
- a second pioneer status or investment tax allowance may be given to a company controlled directly or indirectly by another company which: is a pioneer company or which has been granted an allowance for industries located in a promoted area, engaged in the same promoted activity or promoted product; has been granted pioneer status for the same product or promoted activity; or is a post-pioneer company or a company whose allowance incentive has ended. The law also provides for a pioneer company, a company granted pioneer status or a company granted an investment tax allowance, to apply and be eligible for approval of an allowance for another promoted product or activity within the same company;
- a five year tax holiday for a high technology company engaged in the manufacture of a promoted product in areas of new and emerging technologies such as automation, bio-technology, electronics, building materials, information technology and renewable energy technology. Under this scheme, 100% of its taxable income is exempt from tax (compare with the 85% exemption of statutory income for a manufacturing facility located in a promoted area);
- a high technology company can alternatively be granted an investment tax allowance; that is, an allowance of 60% of qualifying capital expenditure incurred within five years from the date of approval of the incentive will be deducted against the income; and
- a company which has incurred capital expenditure on infrastructure facilities for a business located in a promoted area will be given an allowance equal to 100% of the capital expenditure which must be incurred within five years from October 29 1993. This excludes capital expenditure that qualifies for other tax incentives. Capital expenditure on housing and plant and machinery for the use of the management, administrative or clerical staff do not qualify for this incentive. The statutory income to the extent of the infrastructure allowance given, but not exceeding 85% of the statutory income, will be exempt from tax.

Indirect taxes

Malaysia supports the creation of a free trade area among the members of the Association of South East Asian Nations (Asean) and the Common Effective Preferential Tariff (CEPT) programme which aims to accelerate the reduction of tariffs among Asean members.

In line with the CEPT programme, Malaysia has over the last two years significantly cut or abolished customs and excise duties on a number of goods. The Budget further cuts duties on more than 2600 items.

Similarly, sales tax has also been cut on a number of items including parts and components of heavy machinery.

Exchange controls

An important change introduced by the Budget is the liberalization of exchange controls. With an increase in cross-border transactions, outbound investments and globalization of businesses, the exchange control changes are timely.

One of the most significant is the ability of exporters to retain a portion of export proceeds in foreign currency. Before this amendment, all export proceeds had to be remitted to Malaysia within six months, and converted into the local currency.

Following the changes, certain designated commercial banks are permitted to maintain foreign currency accounts for clients; others must seek approval from the Central Bank. Exporters can operate one multi-currency account to retain export proceeds between US$1 million and US$5 million depending on the level of exports.

Other changes to the existing exchange control regime are:

- residents other than individuals can operate foreign currency accounts to credit foreign currency receivables up to US$0.5 million;
- residents with no domestic borrowings can operate foreign currency accounts with a designated commercial bank or overseas branches of Malaysian banks;
- foreign and local currency borrowings from non-residents need not be separate, and the combined limit is M$5 million for all credit facilities in foreign currency;
- non-resident controlled companies' debt:equity ratio for local borrowings has been relaxed from 2:1 to 3:1;
- external account holders can borrow up to M$200,000 locally and can borrow up to 60% of the purchase price of one residential property;
- hedging transactions involving currency options and other financial derivatives are freely permitted; and
- foreign currency accounts can be operated by operational headquarters.

Tax incentives

Foreign direct investment contributed significantly to the robust economic growth of the last few years. With new markets emerging in Vietnam, Indonesia and China, foreign direct investment has to some extent diverted to those markets with lower production costs.

To maintain sustainable growth and cut dependence on foreign direct investment, the government has initiated measures to stimulate local investment and encourage Malaysian businesses to invest in the manufacturing sector by offering tax incentives.

To increase skilled labour in Malaysia, training incentive schemes were reviewed and incentives have been offered to encourage the provision of technical and vocational training.

A company which participates or intends to participate in providing technical or vocational training in Malaysia may be granted an investment tax allowance. The company will be given an allowance of 100% of the qualifying capital expenditure incurred within ten years from the date of approval.

The allowance must not exceed 70% of the company's statutory income for a particular year of assessment. This incentive also applies to capital expenditure incurred to improve a building, upgrade training equipment or expand training capacity.

Technical or vocational training companies are also eligible for exemptions from import duty, sales tax and excise duty in respect of machinery or equipment, materials, raw materials or samples used for the purposes of training.

Cash donations to a technical or vocational training institute established and maintained by a statutory body are deductible in computing the total taxable income of the donor. The tax residual value of any plant or machinery which is gifted to a technical or vocational training institute established and maintained by the government, or a statutory body or a technical or vocational training institute approved by the Minister of Finance, is deductible to the donor by way of an allowance.

Generally, buildings used for technical or vocational training or for the purpose of research will be depreciable.

An individual who undertakes a course of study in any institution in Malaysia for the purpose of acquiring technical, vocational or industrial skills will be given an exemption of up to M$2,000 on the course fees he or she pays. A new investment incentive was introduced before the Budget. This is described in the box on page 13.

Research and development incentives

To accelerate the technological progress and dispersal of industry in Malaysia, and to enhance research and development in the industrial and agricultural industries, tax incentives are provided for companies undertaking research and development and for the location of promoted industries in promoted areas.

Research and development companies are categorized as follows:

- contract research and development company – a company providing research and development services in Malaysia to unrelated companies;
- research and development company – a company providing research and development services to its related company or to any other company; and
- in-house research company – a company which carries on research and development within the company for the purpose of its own business.

A company carrying out research and development may apply for pioneer status or an investment tax allowance.

The incentives available for each of the three types of research company are summarized in the box above.

Tax incentives for research & development

Type of company	Contract R & D	R & D company	In-house research
Pioneer status			
Years of tax holiday	5	Nil	Nil
Statutory income exempt from tax	100%	Nil	Nil
Investment Tax Allowance (ITA)			
Capital expenditure incurred from approval date	10 years	10 years	10 years
Amount of capital expenditure given as ITA	100%	100%	50%
ITA must not exceed % of statutory income	70%	70%	70%

Tax-free dividends can be distributed out of the exempt pioneer profits or ITA