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Guidelines on the Application of Subsections 12(3) and 12(4) of the Income Tax Act 1967 in Determining a "Place of Business"

The impact on the US companies and others from Non-Treaty Countries

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MAKING AN IMPACT THAT MATTERS since 1845

Foreword

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From the context of inbound operations, we often ask when would a non-resident's ("NR") business profits be subject to Malaysian income tax.

Regardless of whether the NR is from a treaty country or otherwise, the appropriate starting point is the domestic tax law, namely the Malaysian Income Tax Act, 1967 ("MITA"). It is trite law that double tax agreement ("DTA") is not a taxing statute and therefore, if an income or profit arising from a particular transaction or activity is not within the ambit of MITA, the analysis ends there without a need to refer to the DTA. Unlike certain jurisdictions such as Australia and the UK, prior to 28 December 2018, the term permanent establishment ("PE") cannot be found in the MITA.

If the term PE is defined in the domestic tax law, the analysis becomes less complex as one would be able to compare the meaning of PE found there with that of the DTA where the latter prevails. If a particular country does not have a DTA with another country, the concept of PE under the domestic tax law will apply and because the term PE under the domestic tax law is broadly akin to the one in the Organization for Economic Co-operation and Development ("OECD") Model Tax Convention, the OECD's official commentary would certainly aid in interpreting the PE concept under the local law.

Absent the PE concept in the MITA prior to 28 December 2018, herein lies the problem. For example, in the case of the US tax residents operating in Malaysia, the determination of whether there is a source of income from Malaysia will solely be based on the MITA, in particular, Section 3 which reads as the following:

"Subject and in accordance with this Act, a tax to be known as income tax shall be charged for each year of assessment upon the income of any person accruing in or derived from Malaysia or …"

The determination of locality of profit under MITA is a "practical hard matter of facts" and there is no simple legal test to guide us. If the income represents business income to a person, Section 3 must be read together with Section 12:

"(1) Where for the purposes of this Act it is necessary to ascertain any gross income of a person derived from Malaysia from a business of his, then-

(a) subject to subsection (2), so much of the gross income from the business as is not attributable to operations of the business carried on outside Malaysia shall be deemed to be derived from Malaysia;

(b)…"

It is relatively easier to apply Sections 3 and 12 to outbound operations e.g. whether a Malaysian company's profit arising from the provision for services overseas would still be subject to Malaysian tax. This is not necessarily the case for inbound operations.

Therefore, the introduction of Sections 12(3) and 12(4), effective 28 December 2018, provides more certainty in assessing whether the business profits of NR that is from a non-treaty country would fall within the Malaysian income tax net. However, there are several grey areas in the law itself and as such, the issuance of the guidelines by the tax authorities on 21 May 2020 are useful as they alleviate a number of uncertainties. In any case, it is important to note that Section 12(1) must continue to be considered even with the relatively new Sections 12(3) and 12(4) being in place.

It is delightful to note that the guidelines have adopted several key concepts of OECD and United Nations e.g. geographical and commercial coherence, "at the disposal" test, the PE exception rules (preparatory or auxiliary), delivery and order-filing activities that are tied to sales-related activities, anti-fragmentation rules, and the concept of independent agent. The reference to the OECD model is vital as there are various literatures for one to make reference to and hence, reducing the risk of misinterpretation and misapplication.

With the latest development, MNCs from the US and other non-treaty countries should revisit their existing and proposed modus operandi in Malaysia with a view to assessing the implications and the way forward.

Section 12 of the MITA

Prior to 28 December 2018

Subsections (1) & (2)

(1) Where for the purposes of this Act it is necessary to ascertain any gross income of a person derived from Malaysia from a business of his, then-

(a) subject to subsection (2), so much of the gross income from the business as is not attributable to operations of the business carried on outside Malaysia shall be deemed to be derived from Malaysia;

(b) notwithstanding paragraph (a), if the business consists wholly or partly of the manufacturing, growing, mining, producing or harvesting in Malaysia of any article, product, produce or other thing –

(i) the gross income from any sale of the article, product, produce or other thing taking place outside Malaysia in the course of carrying on the business; or

(ii) where the article, product, produce or other thing is exported in the course of carrying on the business and subparagraph (i) does not apply, an amount equal to the market value of the article, produce, product or other thing at the time of its export,

shall be deemed to be gross income of that person derived from Malaysia from the business.

(2) Where in the case of a business to which paragraph (1)(a) applies-

(a) the business or a part thereof is carried on in Malaysia;

(b) any of the gross income of the business (from wherever derived) consists of a dividend or interest to which subsection 24(4) or (5) applies; and

(c) the dividend or interest relates either-

(i) to a share, debenture, mortgage or other source which forms or has formed part of the stock in trade of the business or, where only part of the business is carried on in Malaysia, of that part of the business; or

(ii) to a loan of the kind mentioned in section 24(5) granted in the course of carrying on business or that part of the business, as the case may be,

so much of that gross income as consists of that dividend or interest shall be deemed to be derived from Malaysia.

Section 12 of MITA

Effective 28 December 2018

Subsections (3) & (4)

(3) Notwithstanding subsections (1) and (2), the income of a person from a business that is attributable to a place of business in Malaysia shall be deemed to be the gross income of that person derived from Malaysia from the business.

(4) For the purpose of subsection (3), a place of business includes—

(a) a place of management;
(b) a branch;
(c) an office;
(d) a factory;
(e) a workshop;
(f) a warehouse;
(g) a building site, or a construction, an installation or an assembly project;
(h) a farm or plantation; and
(i) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources,

and without prejudice to the generality of the foregoing, a person shall be deemed to have a place of business in Malaysia if that person—

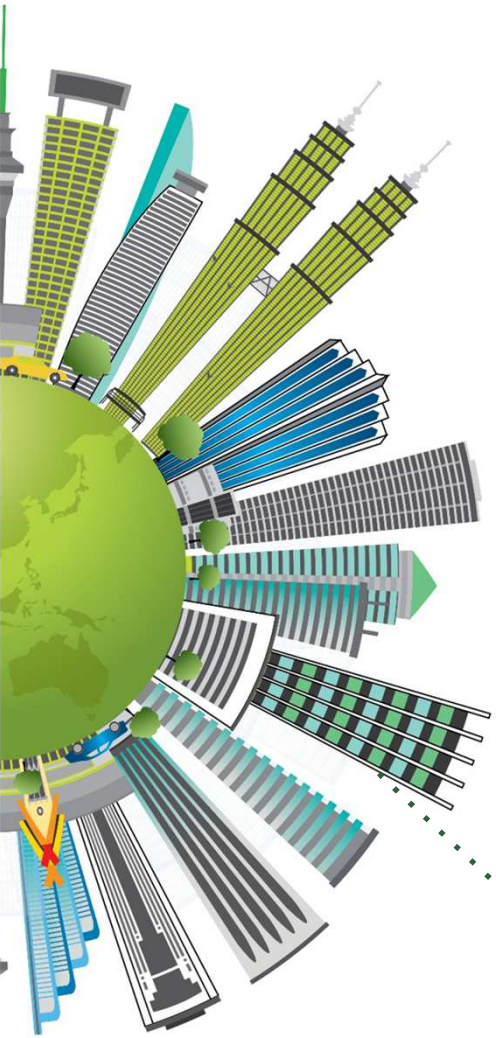
(i) carries on supervisory activities in connection with a building or work site, or a construction, an installation or an assembly project; or
(ii) has another person acting on his behalf who—

(A) habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification;

(B) habitually maintains a stock of goods or merchandise in that place of business from which such person delivers goods or merchandise; or

(C) regularly fills orders on his behalf.

Our Commentary:
When Section 12(3) and Section 12(4) were introduced, the intention (as stated in the Finance Bill 2018) was to provide clarification on the derivation rule for NR from a non-treaty country. However, the guidelines seem to suggest that the derivation rule for NR is now expanded i.e. the general derivation rule provided in Section 12(1) and (2) of the Act would continue to apply.



The guidelines

- Further to the introduction of Sections 12(3) and 12(4) of the MITA which are effective from 28 December 2018, the Inland Revenue Board of Malaysia ("IRBM") has released the Guidelines on the Application of Subsections 12(3) and 12(4) of the Income Tax Act 1967 in Determining a "Place of Business" on 21 May 2020 ("the guidelines") to provide clarification in determining the "place of business" ("POB") of a person in Malaysia based on the application of Sections 12(3) and 12(4) of the MITA.

- Pursuant to Section 12(3) of the MITA, a person is deemed to derive income from a business in Malaysia if that income can be associated with the existence of a POB in Malaysia.

- However, if the NR person is a tax resident of a country which has a DTA with Malaysia, the provisions of the DTA (i.e. Articles on Permanent Establishment and Business Profits) shall prevail.

- The guidelines provide that the application of Sections 12(3) and 12(4) of the MITA would not affect the general derivation rules as provided in Sections 12(1) and 12(2) of the MITA.

Physical "Place of Business"

- A POB may exist where the person has a certain amount of space at its disposal for carrying on its business, regardless of whether the place is owned or rented by that person.

- The POB must be fixed. Two critical components would be considered: -

  a) duration test: a certain degree of permanence at geographical point; and

  b) location test: a specific geographical point. The issue of commercial and geographical coherences would need to be duly considered.

Our Commentary:
Based on the OECD Commentary on Article 5 (PE), the general rule of thumb for the time test for fixed place PE under OECD is 6 months. However, there is no time threshold provided under the guidelines for physical POB.

In this respect, the time test would need to be evaluated on a case to case basis.

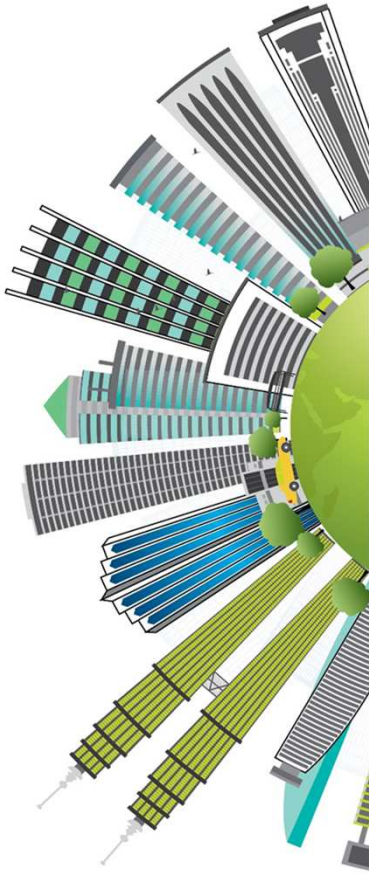
Preparatory or Auxiliary

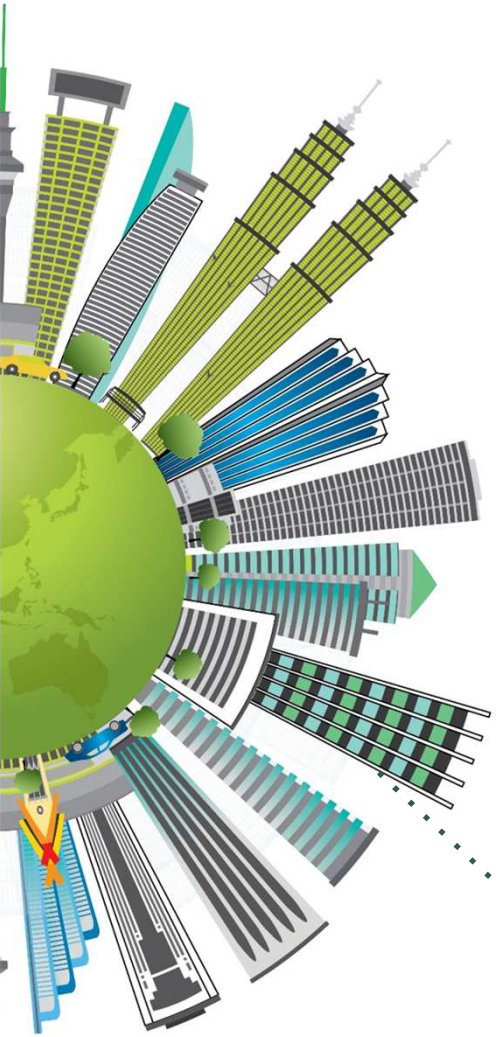
- Where a physical place is maintained solely for the purpose of carrying on an activity which is of preparatory or auxiliary character, such place may not constitute a POB. Activities of preparatory or auxiliary in nature include the following characters:

  - remote from the actual realisation of profit of the business;
  - in itself do not form an essential and significant part of the activity of that business;
  - are not identical to the general purpose of the whole business; or
  - are usually carried out during a relatively short period.

Anti-fragmentation rules

- However, if the overall activity by the person or its associated person resulting from the combination of preparatory or auxiliary activities constitute complementary functions that are part of a cohesive business operation, such activity would not be regarded as preparatory or auxiliary.





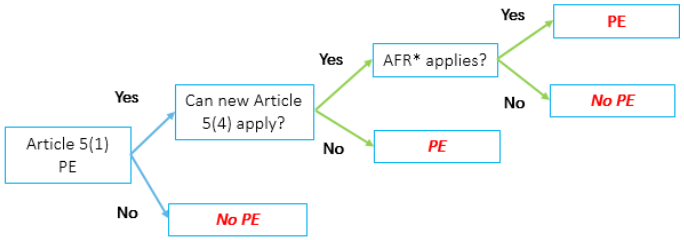
- In Example 5 of the guidelines, a NR company which has a warehouse in Malaysia stores and supplies large items of goods that are sold by its subsidiary in Malaysia, the warehouse is regarded as a "place of business" of the NR company. The IRBM takes the position that the storing activities at the warehouse are not regarded as preparatory or auxiliary as the business activities carried on by the NR company and the subsidiary constitute complementary functions that are part of a cohesive business operation.

Our Commentary:
Example 5 is similar to the example provided in the BEPS Action 7 report on anti-fragmentation rules.

Our Commentary:
The IRBM has applied the OECD's anti-fragmentation rules in the guidelines.

The anti-fragmentation rule was introduced to circumvent a situation where multinational companies fragment their operations among multiple group entities to qualify for the exceptions.

With this, there are several tests to be fulfilled before one can rely on the PE exceptions. We have summarised the tests (per OECD) in the diagram below:



Notes:
- *Article 5(1) – Fixed Place PE*
- *Article 5(4) – PE exception*
- *New Article 5(4) – each activity is subject to preparatory or auxiliary condition*

**AFR – Anti-fragmentation rule*

Building site, construction, installation, assembly project and supervisory activity

- A building site, or construction, installation or assembly project or supervisory activities in connection with such site/ project will be regarded as a POB of a person if the activities at the site or project are for a period or periods exceeding 5 months in aggregate in any 12-month period. In such situation, payment for these types of services would be subjected to withholding tax ("WHT") under Section 107A of the MITA (i.e. interim WHT of 10% + 3%).
- The IRBM has also clarified that for services other than those mentioned in paragraph 3.8 of the guidelines, WHT under Section 109B of the MITA will be applicable (i.e. final WHT of 10% or reduced rate as provided in a treaty).

Our Commentary:
It is noteworthy that a 5-month threshold has been introduced for POB in relation to building site, construction, installation, assembly project and related supervisory activities. The threshold is slightly lower than the threshold as provided in most of the Malaysian treaties (i.e. 6 months).

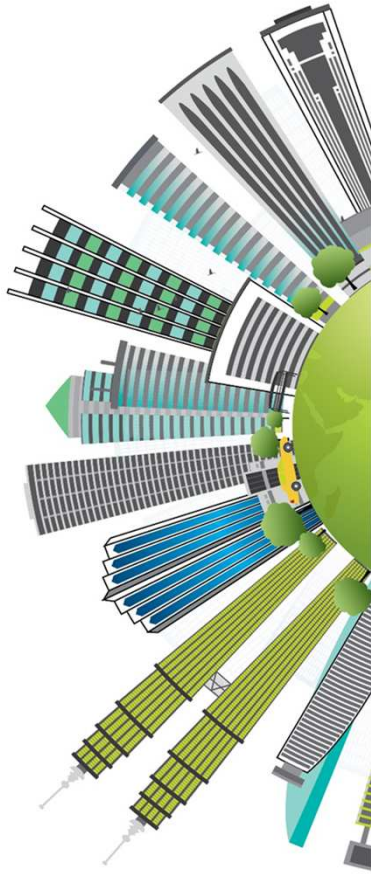
The guidelines are silent on how to compute the time spent by the NR in Malaysia with regards to related supervisory activities (i.e. based on the number of days that the NR carries out the work physically in Malaysia or based on project period). Further clarification would need to be sought from the IRBM.

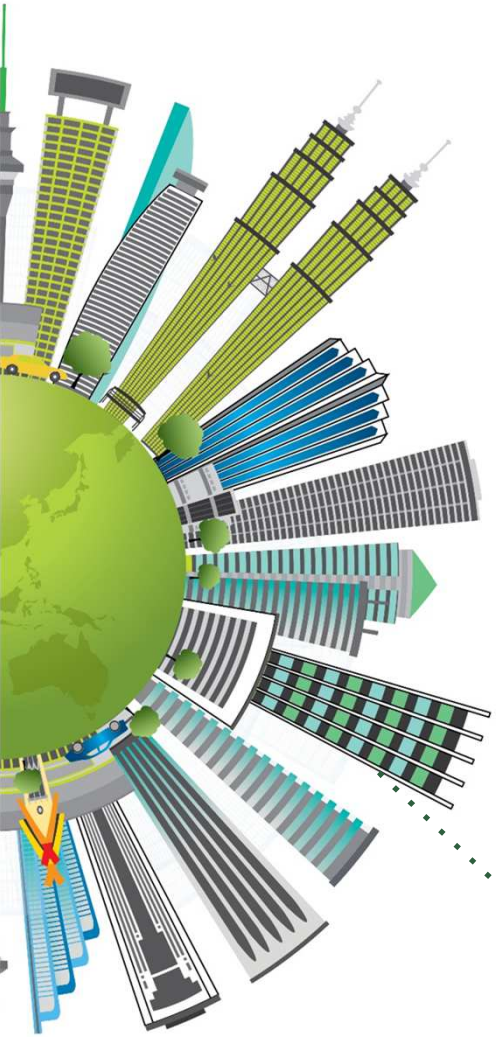
- For the purpose of determining the duration of activities, the period of activities carried on by a person and its associated persons in Malaysia shall be aggregated if the activities carried on by associated persons are connected with the activity of that person.

- Different activities will be regarded as connected based on the facts and circumstances of the case. This include the following: -

  a) whether the contracts covering the different activities were concluded with the same person or its associated persons;
  b) whether the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with the person or its associated persons;
  c) whether the activities would have been covered by a single contract absent tax planning considerations;
  d) whether the nature of the work involved under the different contracts is the same or similar;
  e) whether the same employees are performing the activities under the different contracts.

Our Commentary:
Whilst Malaysia has opted out of the anti-BEPS measure on contract splitting under Article 14 of the Multilateral Instrument ("MLI"), the IRBM has included some elements on contract splitting in the guidelines.





Agent as "Place of Business"

- A person (principal) may also be deemed to have a POB in Malaysia if the person has another person (agent) acting on his behalf who:

  a) habitually concludes contracts; or

  b) habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification.

- The type of contracts covered include those which are in the name of the principal or which are binding on the principal even if those contracts are not in the name of the principal.

Our Commentary:
The above is in line with the provisional position of Malaysia in Article 12 of the MLI. With this, a company that carries out sales and marketing activities for its foreign principal in Malaysia may need to assess the risk of a POB for the principal in Malaysia.

- In addition, a person (principal) may also be deemed to have a POB in Malaysia if he has an agent who:

  a) habitually maintains a stock of goods or merchandise in that place of business of the person from which such person delivers goods or merchandise; or
  b) regularly fills orders on behalf of the person.

- The guidelines provide that the stock maintenance and delivery or order filling POB may only be created for the NR principal if the agent also conducts sales-related activities in addition to regularly delivering or regularly filling orders out of the stock of goods or merchandise belonging to the principal.

Our Commentary:
In terms of the POB in relation to delivery or order filing agent, it seems that Malaysia has adopted the position in the UN Commentary on Article 5 (i.e. a POB would only be created if the NR also carries out sales related activities). The same position may be adopted by the IRBM in interpreting delivery or order dependent agent PE in the tax treaty which contains such provision.

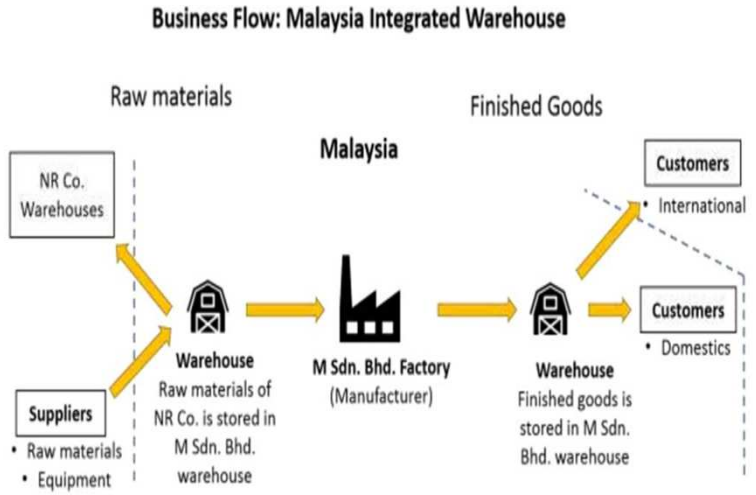
Agent as "Place of Business"

- It is worth noting that the IRBM has clarified that independent agents who act for a NR in the ordinary course of their business do not constitute a POB of the NR. However, a person is not an independent agent if he acts exclusively, or almost exclusively, on behalf of one or more associated persons.

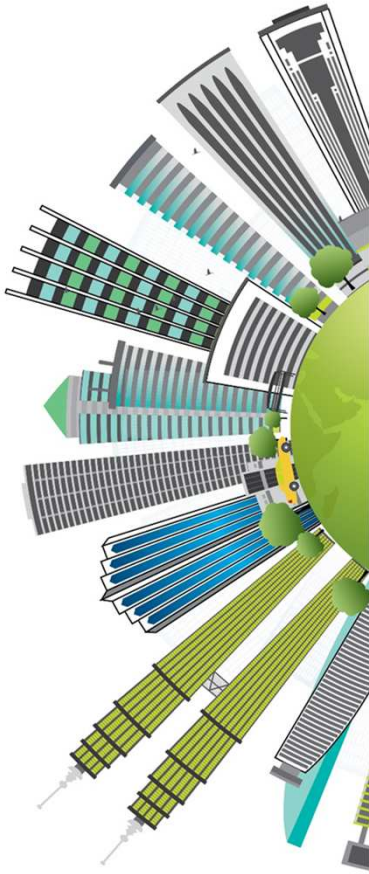
Our Commentary:
The exclusion of agents of independent status is in line with the Commentaries in the OECD/UN Model Tax Convention. This should supersede the IRBM's previous position (i.e. a NR would create a POB in Malaysia even if the NR has an independent agent in Malaysia who maintains a stock of goods or merchandise belonging to the non-resident in Malaysia for delivery purposes).

Illustration of Place of Business in Malaysia

- The following chart is extracted from Example 9 of the guidelines which illustrates the application of Sections 12(3) and 12(4) of the MITA in determining the POB of a person in



- Some important facts:-
  1. NR Co has a sales office in Malaysia.
  2. NR Co stores its goods in the warehouse owned by its related company in Malaysia.
  3. NR Co does not have unlimited access to the warehouse.
  4. The goods would be delivered to NR Co's Malaysian and foreign customers.



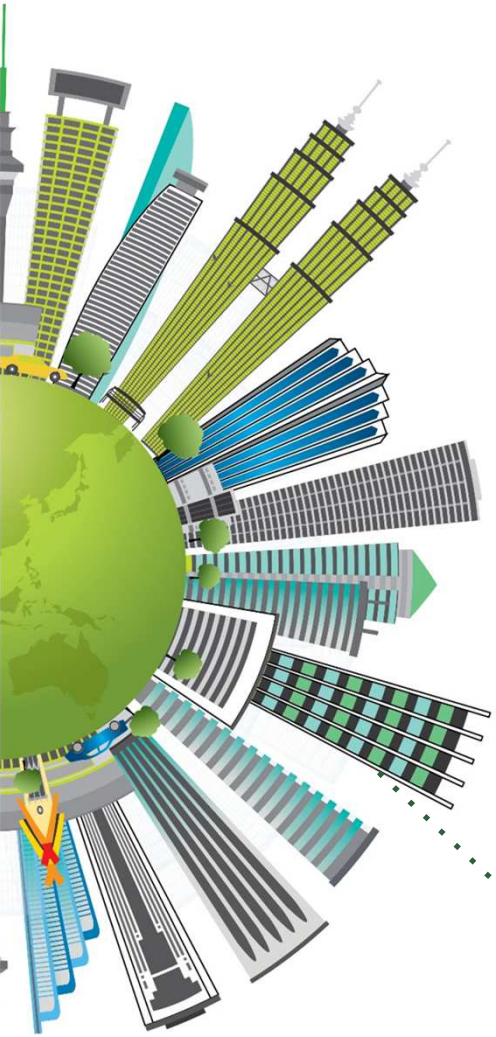


Illustration of Place of Business in Malaysia

- The IRBM is of the view that the warehouses by themselves do not constitute as POB to NR Co as the warehouses are not at their disposal. However, the overall activities of warehousing and manufacturing by M Sdn Bhd and marketing by NR Co's sales representative office constitute complementary functions that are part of a cohesive business operation of NR Co which results in NR Co having a POB in Malaysia.

Our Commentary:
In Example 9, although the warehouses are not at the disposal of the NR, the NR's sales representative office in Malaysia would constitute a place at the NR's disposal. Whilst marketing activity carried on in the sales representative office may qualify as preparatory or auxiliary, anti-fragmentation rule would need to be considered. Hence, the conclusion for Example 9 is that there is a POB in Malaysia.

Overall commentary

- The guidelines have adopted several key concepts of the 2017 OECD and United Nations Model Tax Convention e.g.
  - ✓ Fixed place of business with "at the disposal" test, geographical and commercial coherence consideration
  - ✓ Activities which are of preparatory or auxiliary character
  - ✓ Delivery and order filling activities that are tied to sales-related activities
  - ✓ Anti-fragmentation rules
  - ✓ Contract splitting
  - ✓ Independent agent concept
- Credit must be given to the IRBM as these guidelines shed light on the interpretations of subsections 12(3) and (4). As the guidelines have no force of law, it is best for the points in the guidelines to be incorporated into the Act. In any case, there would be a legitimate expectation for these to be respected.

- The income of a NR attributable to a POB in Malaysia shall be deemed derived from Malaysia and is subject to Malaysian income tax. The NR would need to file income tax return in Malaysia and is subject to corporate tax compliance requirements such as the filing of tax estimate, record keeping etc. Whilst lodging the Malaysian corporate tax return by the NR may be a routine compliance exercise, the more challenging issue here is the profit attribution for the Malaysian operations, which is complex and often subject to dispute. We expect the IRBM to issue separate guidelines on profit attribution to the POB in due course.

Overall commentary (cont'd)

Some salient points in determining POB/ PE moving forward

NR from US and other non-treaty countries

- Sole authority: MITA (Section 12)
- Certain MLI features have been incorporated in the MITA (principal role test for agent) and the guidelines (e.g. anti-fragmentation etc).

NR from treaty countries

Before the Malaysian MLI is effective
Article 5 of the DTA (DTA prevails over MITA)

Once the Malaysian MLI is effective

- Article 5 of the DTA (DTA prevails over MITA)
- MLI impact : the extent to which the MLI modifies an existing tax treaty would depend on
  - the final MLI positions adopted by Malaysia* such as principal role leading to conclusion contract for agency PE, tightening of definition of independent agent, specific activity exemption and anti-fragmentation rules; and
  - MLI positions adopted by the relevant treaty country.
- Based on the provisional positions, Malaysia has chosen to adopt all anti BEPS measures on Action 7 on PE (save for splitting-up of contracts). However, it does not necessarily mean that all existing tax treaties with Malaysia would be modified accordingly to include such measures given that certain countries may not subscribe to the same.

*Note: Malaysia has not ratified the MLI as of to-date. It is expected that the ratification will take place by the end of this year. The MLI will only come into effect upon the deposit of instrument of ratification of the MLI by both treaty country and Malaysia and once a specific time has passed.

What is next?

Assessing existing and proposed operations in Malaysia

Common business models in Malaysia would include:

- Limited risk distribution
- Full-fledged, contract and toll manufacturing
- Sales and marketing support

Determining the risk of creating a POB and profit attribution exercise

- A thorough analysis should be performed to ascertain if there is a POB in Malaysia.
- If necessary, a confirmation could be sought from the IRBM to confirm the position.
- Once POB position is ascertained, profit attribution exercise should be performed.

Decision on lodging tax returns

- The Malaysian annual corporate tax return is due within 7 months after the closing of accounting period.
- Depending on the result of the profit attribution exercise, taxpayer may approach the IRBM to discuss if there is a need to submit a tax return in Malaysia (i.e. in the case where the profit attributed to the PE is zero). Even if there is a profit attributable to a PE, the taxpayer may consider approaching MIRB to explore if the profit could be taxed in the hand of the associated company (e.g. dependent agent) where the associated company's activities give rise to the POB (e.g. by making an adjustment to the chargeable profit of the associated company) rather than submitting a separate tax return.

Restructure the value chain

- Restructure the value chain to develop and implement a business led structure which is scalable and sustainable.
- if need be, the group transfer pricing documentation would also need to be revised to take into account the changes.

Speak to us

If you have questions on Section 12, permanent establishment or any cross-border tax matters, please get in touch with your usual contact at Deloitte or any of us from the International Tax Services Group:

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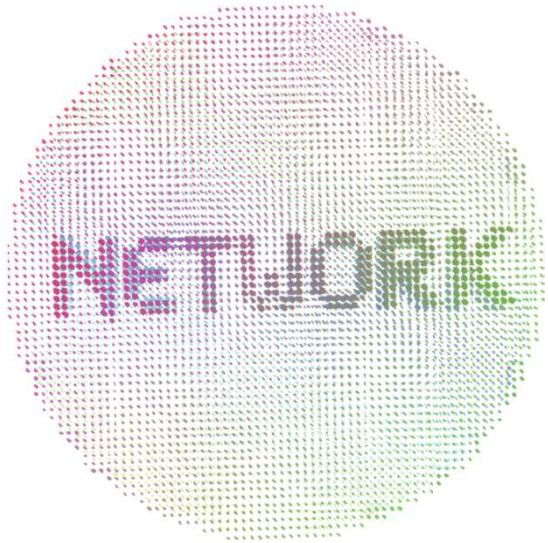

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