

e-Announcement



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Dear Valued Client / Business Associate,

Withholding Tax (“WHT”) on Royalty and Service Fee Payments to Non-Residents – Proposed Changes under the Finance Bill 2016

The Finance Bill 2016 was passed by the Dewan Rakyat on 23 November 2016 and includes significant changes to the Malaysian WHT treatment of royalty and service fee payments made to non-residents, as summarised below:

- a) A significant expansion of the definition of “royalty” to include payments for the use of, or the right to use, or the alienation of software, amongst others; and
- b) The imposition of WHT on services rendered by non-residents, regardless of whether such services are rendered within or outside Malaysia.

The proposed changes, if passed into law, would be effective upon the coming into operation of the Finance Act 2016, which is expected in late 2016 or early 2017.



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Overview of the Current WHT Regime for Royalties and Service Fees

Payments of royalties and service fees derived from Malaysia and paid or credited to non-residents are subject to WHT at the rate of 10%, which may be reduced under an applicable double taxation agreement (“DTA”). Generally, such payments would be deemed to

be derived from Malaysia if:

- responsibility for payment lies with a Malaysian tax resident, the Government, a State Government or a local authority; or
- the payment is charged as an outgoing or expense:
 - a) against any income accruing in or derived from Malaysia (**for royalties**); or
 - b) in the accounts of a business carried on in Malaysia (**for service fees**).

The payer is responsible for withholding the tax and remitting the same to the Malaysian Inland Revenue Board (“MIRB”) within 1 month of paying or crediting the non-resident. Although WHT is imposed on the non-resident recipient, non-compliance with the WHT provisions would give rise to penalties and adverse tax implications for the payer.

Expansion of the Royalty Definition

Prior to the Finance Bill 2016, the WHT treatment of royalties, particularly in relation to payments for software (including associated intangibles and services) has been an area of significant uncertainty. There have been several Malaysian court cases concerning the imposition of WHT on such payments.

The proposed royalty definition is extensive and differs considerably from the prevailing domestic and DTA definitions, as well as guidance on royalties in the Organisation for Economic Co-Operation and Development’s Commentary (which seeks to align international tax practices and is generally used as a reference by many other jurisdictions).

Even in situations where payments are not regarded as royalties, WHT may be applicable where payments fall within the “Special Classes of Income” under Section 4A of the Income Tax Act, 1967 (“the ITA”), discussed in further detail below.

Imposition of WHT on Services Rendered by Non-Residents Outside Malaysia

WHT at the rate of 10% (unless reduced by a DTA) is applicable on payments to non-residents falling within the ambit of Section 4A(i) to (iii) of the ITA.

Under the current WHT provisions for service fees, WHT would only be applicable (with effect from 21 September 2002) to service fees falling within Sections 4A(i) and (ii) where the services are rendered in Malaysia. These cover the following payments:

- (i) Service fees in connection with the use of property or rights belonging to, or the installation or operation of any plant, machinery or other apparatus purchased from, a non-resident.
- (ii) Service fees for technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme.

The Finance Bill 2016 proposes to remove the distinction between services rendered within or outside Malaysia, such that all services rendered by a non-resident and derived or deemed to be derived from Malaysia should be subject to WHT.

From a technical standpoint, the proposed change is controversial, particularly given the legislative and case law history in relation to the tax treatment of Section 4A income. Notably, there have been court cases whereby the MIRB asserted its right to tax income falling within the domestic definition of special classes of income (but viewed by the non-resident as business income, which should be afforded DTA protection in the absence of a permanent establishment). Whilst these cases were decided on their specific facts, the generally accepted principle is that the DTA provisions should take precedence over domestic law. However, the MIRB has not issued its views or guidance on how the Finance Bill 2016 changes would impact the tax treatment under Malaysia's DTAs.

Key Tax Implications Arising from the Above Changes

In view of the above, taxpayers making payments to non-residents, particularly in respect of software / intangible property and service fees are advised to undertake the following measures:

1. Review cross-border contractual and payment arrangements in light of the Finance Bill 2016 changes to assess whether WHT applies.
2. Determine whether preferential treatment under a DTA is available. This would entail reviewing each applicable DTA (particularly Articles concerning Business Profits, Royalties, Technical Fees and Other Income, to the extent that the DTA contains such Articles) and considering how the proposed changes will interact with the relevant DTA.
3. Ascertain which party is responsible for bearing the WHT. In the absence of an agreement between the parties to the contrary, WHT is a tax on the non-resident, whilst the compliance obligations (and associated penalties) fall on the payer. The terms under existing contracts may have to be discussed and/or renegotiated if impacted by the proposed WHT changes. If the WHT is borne by the payer, the tax implications have to be considered.

The above are some non-exhaustive suggestions on preliminary matters to consider. Where it is determined that your organisation may be affected by the proposed changes, it may now be appropriate to commence looking at options to restructure existing cross-border arrangements and to formulate strategies for dealing with future transactions.

Practical Issues

In the absence of MIRB guidance or clarification on the application of the proposed changes (including the interaction between domestic law and a DTA), there may be uncertainty over the tax

treatment of certain payments. The Finance Bill 2016 does not contain any "grandfathering" provisions for existing agreements. Transitional measures have also not been announced.

In response to the concerns and queries and comments raised by the various professional bodies, the MIRB has indicated that it will issue guidelines shortly (however, no exact timeframe has been given). We will provide updates in our future e-Announcements when further information is forthcoming.

In the interim, entities making payments to non-residents should give careful consideration to the implications arising from the above proposed changes.

If you require our assistance in addressing the potential impact of the WHT changes for your organisation, please do not hesitate to contact any of our Executive Directors, Directors, Associate Directors or Managers whom you are accustomed to dealing with or who are responsible for the tax affairs of your organization at the telephone number (603) 7721 3388.

Regards,

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This message has been approved for distribution by Tai Lai Kok and Ong Guan Heng.

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