With a worldwide focus on globalisation and the continuous advancement in transportation and telecommunications, many businesses have expanded rapidly in recent years, and conducting business across international boundaries is now the norm.

Malaysia has continued to attract Foreign Direct Investment (FDI) inflows and achieved the third-highest level of FDIs in Southeast Asia in 2011 at US$12 billion, behind Indonesia and Singapore.

To several significant tax implications, which can have an impact on the overall cash-flows and financial efficiency of cross border transactions, particularly where the tax issues are not addressed at the outset.

This is a two-part article, Part One of which discusses the key Malaysian tax implications arising from conducting cross border transactions, while Part Two will explain how effective tax rates can be minimised through the use of tax treaties.

MALAYSIA TAKES 5TH LARGEST FDI IN ASIA

Malaysian entities are also investing on an outbound basis and Malaysia was the fifth largest source of FDI in Asia in 2011, with outflows reaching US$ 15 billion.

While domestic and cross border transactions are becoming increasingly simpler to administer in terms of communication and transaction costs, international transactions can give rise to several significant tax implications, which can have an impact on the overall cash-flows and financial efficiency of cross border transactions, particularly where the tax issues are not addressed at the outset.

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CROSS BORDER TRANSACTIONS – MALAYSIAN TAX CONSIDERATIONS

Investing abroad

The continuous increase in FDI outflows suggests that Malaysian companies are increasingly investing abroad, whether to penetrate international markets or to undertake specific projects overseas. Investments abroad can yield various types of income for Malaysian companies, and understanding the tax implications arising therefrom is important to ensure that these investments are structured efficiently from a tax perspective.

Generally, Malaysia operates a territorial scope of taxation such that only income accruing in or derived from Malaysia is taxable in Malaysia. Income derived from sources outside Malaysia and

The first of a two-part series on cross border transactions and the effective use of tax treaties.
received in Malaysia is exempt from Malaysian tax except in certain cases. The question of whether income is derived from sources within or outside Malaysia is not always a straightforward one.

The taxability (under the domestic legislation) of the types of income which are commonly derived by Malaysian companies from investing abroad is discussed below.

- Business gains or profits can arise from the direct supply of goods and/or services by a Malaysian company to subsidiaries and/or customers outside Malaysia.

Generally, where business operations are seen to be carried on within Malaysia, income generated from such business operations would be regarded as being accrued in or derived from Malaysia. Where business operations do not exist in Malaysia, then it would be difficult to contend that income generated from such business operations arises in Malaysia.

The determination of the source of business income is typically a question of fact. However, case law decisions offer guidance as well and the key test looks to where the operations giving rise to the income are carried out. Generally, if the business operations are largely managed in Malaysia (e.g., with key decisions and strategies taking place in Malaysia), income generated from such business is likely to be deemed derived from Malaysia, notwithstanding that a portion of the services may be rendered outside Malaysia. Under such circumstances, such income would be taxable in Malaysia.

- Interest income is usually derived from the lending of funds to subsidiaries outside Malaysia. Based on Malaysian tax rules, interest is deemed to be derived in Malaysia under the following circumstances:
  
  (i) If the payer is a tax resident for the year;

  (ii) If the interest is payable in respect of money borrowed and employed in or laid out on assets used in or held for the production of any gross income derived from Malaysia, or the debt in respect of which the interest paid is secured by any property or asset situated in Malaysia; or

  (iii) If the interest is charged as an outgoing or expense against any income accruing in or derived from Malaysia.

Based on the above, interest income received from a non-resident subsidiary which carries on a business outside Malaysia should not be deemed to be derived from Malaysia. However, the Malaysian tax authorities are known to have adopted a narrow view of interest income being deemed to have a domestic source where funds giving rise to the interest income have originated from Malaysia. Nevertheless, based on a recent case law decision, interest income would likely constitute foreign sourced income (and hence not taxable in Malaysia) if the lending arrangement takes place outside Malaysia, i.e., if the agreement and the provision of credit are not made in Malaysia.

- Dividend income usually arises from the investment in shares by a Malaysian company in subsidiaries or associated companies outside Malaysia. Unlike the derivation rules for business income and interest, the rules for determining the source of dividend are somewhat clearer. Malaysian tax rules provide that the location of the source of dividend income depends on the country of tax residence of the company distributing the dividend. Hence, dividends distributed by subsidiaries outside Malaysia, who are not tax residents of Malaysia, would not be subject to tax in Malaysia.

Due to differences in tax rules for various countries, it is possible that the same income is subject to both Malaysian and foreign taxes, typically in the form of withholding taxes. Under such circumstances, tax relief is generally available for Malaysian resident companies. Where a tax treaty exists between the two countries, bilateral tax relief is given to the Malaysian company for foreign tax suffered on income taxable in Malaysia. The relief is restricted to the lower of Malaysian tax payable on the foreign income or the foreign tax paid. Where a tax treaty does not exist, unilateral tax relief is given but limited to half of the foreign tax payable on that income. It should be noted, however, that in view of the foreign sourced income exemption, where foreign sourced income is exempt from tax in Malaysia, relief would not be available in respect of tax suffered overseas, as the incidence of double taxation would not arise.

**PAYMENTS TO OVERSEAS COMPANIES FOR THE SUPPLY OF SERVICES**

Most businesses will procure some form of services or goods from overseas vendors/suppliers. It is also common for multinational companies operating in Malaysia to make various payments to their parent companies outside Malaysia, such as interest, royalties and fees for support services.

<table>
<thead>
<tr>
<th>Royalties</th>
<th>10%</th>
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<tbody>
<tr>
<td>Interest</td>
<td>15%</td>
</tr>
<tr>
<td>Payments which represent casual/miscellaneous income of the non-resident (i.e., received outside the course of its ordinary business)</td>
<td>10%</td>
</tr>
<tr>
<td>Payments to non-residents as listed under Section 4A of the ITA:</td>
<td></td>
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<tr>
<td>i) Services rendered which relate to the use of non-resident’s property or rights or the installation or operation of any plant, machinery and apparatus purchased from the non-resident (to the extent that services are rendered in Malaysia),</td>
<td>10%</td>
</tr>
<tr>
<td>ii) Technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme (to the extent that services are rendered in Malaysia),</td>
<td>10%</td>
</tr>
<tr>
<td>iii) Rental for the use of moveable properties</td>
<td>10%</td>
</tr>
</tbody>
</table>
It is important to note that certain payments made to non-residents are subject to Malaysian withholding tax at the following rates:

In practice, the Malaysian tax authorities take a broad interpretation of item (ii) mentioned above such that any form of services rendered in Malaysia by non-residents (with the exception of routine day-to-day management and administrative services provided by a head office) are subject to withholding tax. Where the rendering of services by non-residents gives rise to a taxable business presence or a permanent establishment in Malaysia, the withholding tax rate is increased from 10% to 13%.

It should be noted that withholding tax is not a separate class of tax. It is simply a mechanism for collecting income tax where non-residents derive income from Malaysia. Malaysian tax rules impose the obligation of collecting the tax on the payer, via a withholding mechanism. The collection mechanism is enforced via the imposition of penalties on the payer where the tax is not withheld on a timely basis, combined with disallowing a deduction for the fees paid to the non-resident if the tax is not withheld. Therefore, Malaysian resident companies making payments to non-residents would need to be aware of the extent of their withholding tax obligations.

Where payments are made to non-residents situated in a country which has concluded a tax treaty with Malaysia, there may be an avenue for the withholding tax rates to be reduced. This will be discussed in greater detail in Part 2 of this article.

CONCLUSION
Whilst it is a priority for most businesses to structure cross border transactions such that they meet corporate objectives, tax issues surrounding these transactions should not be ignored. With the right planning strategies, cross border transactions which are in line with business objectives can also be tax efficient such that tax costs are minimised. Part 2 of this article will review how the use of tax treaties can assist in achieving this objective.

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