SINGLE TIER TAX SYSTEM

1) INTRODUCTION

Prior to 1 January 2008, Malaysia adopted the imputation system which required the imposition of tax on the profit at corporate level and again at shareholders level. The principle behind the imputation system is to overcome the double taxation of income. Under the imputation system, companies resident in Malaysia are required to deduct tax at source at the prevailing corporate tax rate on dividends paid to their shareholders. The same income would be taxed twice if the credit is not imputed to the shareholders.

The single-tier tax system was introduced in Budget 2008 to replace the imputation system with effect from year of assessment 2008. Under this system, corporate income is taxed at corporate level and this is a final tax. Companies may declare single tier exempt dividend that would be exempt from tax in the hands of their shareholders.

There are a few reasons for the move to the single tier system. First, the imputation system was not able to accommodate increasingly sophisticated business transactions. Second, the obligation of resident companies to maintain the franking account which entailed high compliance costs. Third, to remove the constraint that a company might have distributable profit and yet could not frank dividend because of insufficient credits.

2) COMPARISON BETWEEN IMPUTATION AND SINGLE TIER TAX SYSTEMS

Imputation System	Single Tier System
• Tax paid by a company is not a final tax • Tax is deducted from dividend paid, credited or distributed to shareholders • Shareholders are taxed on gross dividends received and entitled to claim section 110 set-off • Tracking mechanism through section 108 account	• Tax paid by a company is a final tax • No tax is being deducted from dividend paid, credited or distributed to shareholders • Dividends are exempt in the hands of shareholders • No tracking mechanism is required

3) TRANSITIONAL PERIOD

The section 108 balance is a tax credit balance which a company can pay dividend under the imputation system. Many companies may still have substantial section 108 balances as at 31 December 2007. If the single tier system were implemented without any transitional period, companies would have forfeited those credits and most shareholders, especially individuals, would lose out on the tax refunds. Thus the government has allowed a six-year transitional period (1 January 2008 to 31 December 2013) to enable companies with unutilized balances to continue to pay franked dividends during the period. Shareholders who received such dividends are entitled to claim section 110 set-off against their tax payable.

During the six-year transitional period, all resident companies are required to comply with the transitional provisions. The transitional provisions spell out, among other things:

- i) the six-year transitional period allowed resident companies to utilize their section 108 balances as at 31 December 2007;
- ii) companies with nil section 108 balances as at 31 December 2007 would automatically be able to declare single tier exempt dividend from 1 January 2008;
- iii) companies that have utilized all the section 108 balances anytime during the transitional period are not entitled to deduct tax from dividend paid or distributed. Instead, the companies are to declare single tier exempt dividends there from; and
- iv) companies have the option of disregarding the section 108 balances in order to declare single tier exempt dividends during the transitional period.

A) For the purpose of applying the transitional provisions, reference would be made to section 108 balance as at 31 December 2007. The balance is determined as follows:

- i) the amount of the balance for the credit of that company at the end of the basis period for year of assessment 2007 would be increased by:
  - a) any tax paid during the period from the first day of the basis period of that company for the year of assessment 2008 to 31 December 2007; or
  - b) the final instalment paid under section 107c of the Income Tax Act 1967 for companies whose financial years end on 31 December.
- ii) the amount of the balance for the credit of that company would be decreased by:
  - a) any dividend paid during the period from the first day of the basis period of that company for the year of assessment 2008 to 31 December 2007; or
  - b) any tax discharged, remitted or refunded until 31 December 2007.

As a concession, companies are allowed to increase their section 108 balances as at 31 December 2007 by an amount equivalent to:

a) amount of section 110 set-off on dividends received on or before 7 September 2007; and

b) the amount of advance payment made on or before 7 September 2007.

(Refer to Appendix 1)

B). Determination of section 108 balance during the transitional period.

i) during the transitional period, any tax paid or tax charged on any assessment or composite assessment made after 31 December 2007 are not to be added to the 108 balance or revised 108 balance.

ii) section 108 balance or the revised balance would be adjusted downwards by the followings:

a) any dividend paid from 1 January 2008 to 31 December 2013; or

b) amount of tax paid which has been taken into computation of section 108 balance is discharged, remitted or refunded from 1 January 2008 to 31 December 2013.

(Refer to Appendix 2)

4) ANTI AVOIDANCE PROVISIONS DURING THE TRANSITIONAL PERIOD

To avoid manipulation and to safeguard the government from the adverse effect of having substantial outflow of fund due to unexpected increase of tax refunds during the transitional period, the government has imposed conditions as stated below:

i) franked dividends paid by companies must be in cash in respect of ordinary shareholdings. Companies are neither allowed to credit to nor to contra the dividends against their shareholders' accounts;

ii) companies cannot pay franked dividends and single tier exempt dividends to ordinary shareholders concurrently if the companies still have section 108 balances. Companies must utilized all 108 balances in their section 108 accounts before declaring single tier exempt dividends;

iii) shareholders are not entitled to section 110 set-off if the shareholding period is less then 90 days from the date of acquisition to the date of disposal. However, this condition does not apply to shares in companies listed on Bursa Malaysia;

iv) for companies that receive franked dividend (which are of non business source), the statutory income from franked dividends is deemed to be the total income with effect from year of assessment 2008;

v) companies may declare single tier exempt dividends or to pay dividends in specie to their preference shareholders.

5) IMPACT OF THE SINGLE TIER SYSTEM

Some of the benefits and drawbacks of the single tier system are as follows:

Benefits

i) reduce administrative cost and enhance efficiency (for companies and government) as there is no need to maintain section 108 balances;

ii) companies with huge section 108 balances may pay special dividends during the transitional period. Companies with capital gains and non taxable accounting profits are also able to declare dividends without any constraint. Thus shareholders may enjoy higher dividend yields;

iii) high income bracket individuals need not pay tax on the differential between his marginal tax rate and the corporate tax rate; and

iv) reduces tax leakages as the dividends are exempt from tax. Any manipulation to shift tax burden on dividends ceased to serve its purpose.

Drawbacks

i) the holding costs (interest on loans, bonds etc) that are attributable to the financing of investments will no longer be tax deductible once dividends becomes single tier exempt dividends. Corporations need to undertake a tax review on how their investments are held and funded.

ii) issuers of fixed rate preference shares need to ascertain whether the coupon rate specified is a gross or net rate as there may be additional cost on payment of dividends;

iii) individuals with lower income such as pensioners and retirees will not enjoy any tax refunds. Such refunds may represent an important source of fund for this category of persons. Tax exempt bodies and non-profit organizations will also lose the right to tax refunds; and

iv) increase cash flow for government as companies may maximize dividend payouts during the transitional period.

6. CONCLUSION

The change in the tax structure from imputation to the single tier system is the most significant change in Malaysia’s tax laws. The government realized that imputation system is not sustainable anymore in the long run. If tax rates were to be reduced further in the future, the government needs a system that will allow company tax to be deemed as a final tax. The government certainly has taken a bold step to move in the right direction.

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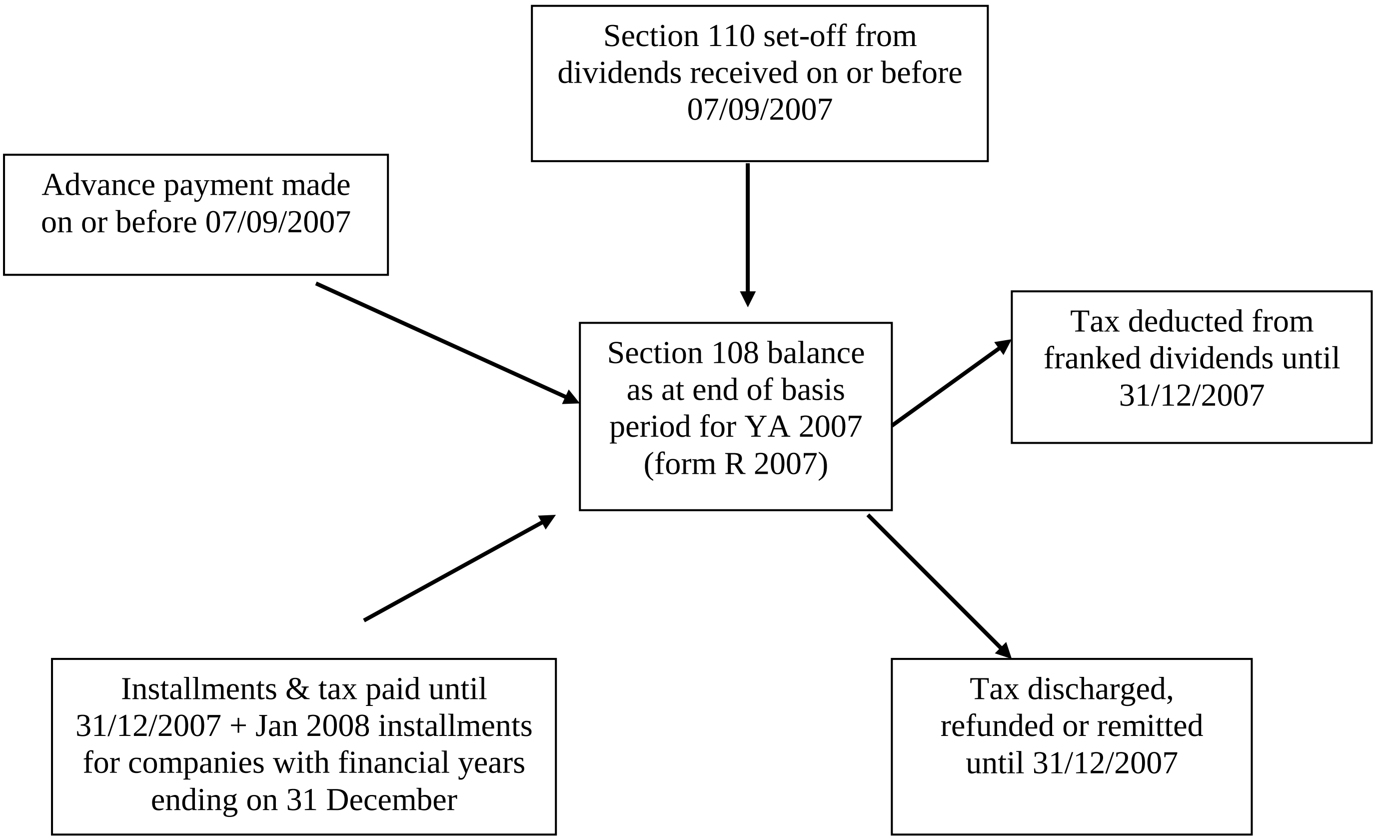
Appendix 1

DETERMINATION OF SECTION 108 BALANCE AS AT 31 DECEMBER 2007



Appendix 2

DETERMINATION OF SECTION 108 BALANCE DURING THE TRANSITIONAL PERIOD