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# Business Restructuring: Tax Checklist

In undertaking a business restructuring in Malaysia, it is important that the rationale for the restructuring be documented.

The shift in global economic activity to Asia over the past few years present many opportunities and challenges for multinationals (MNCs). With economic growth in countries such as China, India, and other Asian countries far outstripping that in the West, Asia is undoubtedly the place to be.

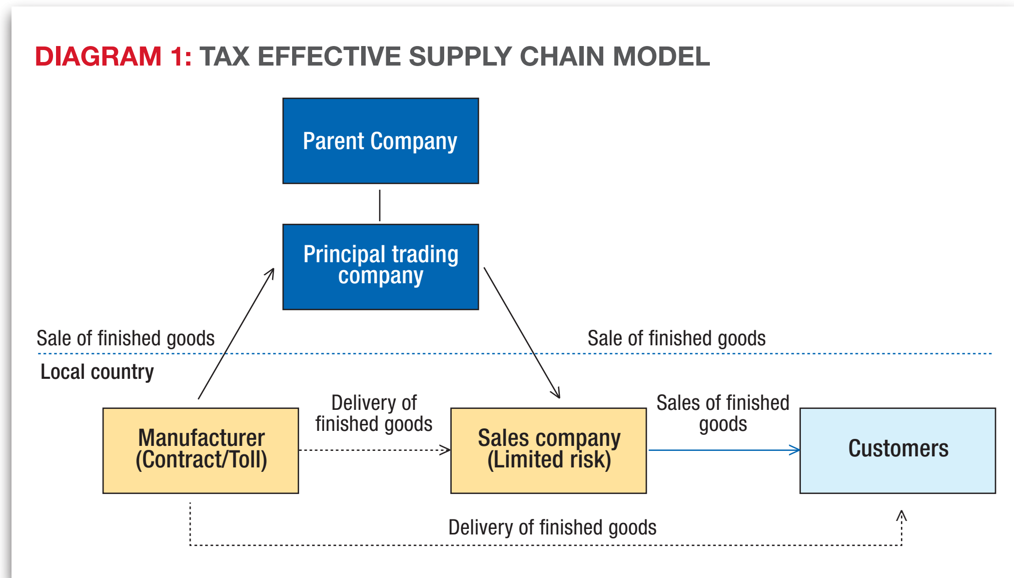
Many first movers into Asia grew rapidly in an unplanned manner through organic growth or mergers and acquisitions where the focus was more on achieving individual company performance in these countries rather than in achieving an operationally effective structure from a Group perspective.

Decentralised management, a web of legal entities, duplication of functions across companies and business units, complex transaction flows and high transaction costs are often the unfortunate side effects of these rapid expansions. More recently many MNCs have had to revisit their operational and organisational structure to identify opportunities to improve business performance and profitability.

There are a number of issues that need to be considered and managed in a business restructuring, be it operational, legal or financial. This article seeks to outline some broad tax issues and considerations that need to be borne in mind when looking at business restructuring in Malaysia.

## A TYPICAL TAX EFFECTIVE SUPPLY CHAIN MODEL

Diagram 1 above shows a typical tax



effective supply chain model. Under this structure, a global or regional Principal trading entity is established for all or part of the supply chain.

The Principal would typically be set-up in a low tax jurisdiction such as Singapore. The Principal would undertake the majority of functions, own key assets and bear the risks thereon while existing full-fledged manufacturing entities located in countries like Malaysia will be converted to contract or toll manufacturers, or alternatively full-fledged distributors to limited-risk distributors.

This structure would effectively shift functions, assets, risks and consequently significant profits to the Principal country. It will result in a contraction in the local businesses' profits and significant reduction in the domestic tax base post-restructure.

## CONTROVERSY ASSOCIATED WITH BUSINESS RESTRUCTURING

Controversy associated with business restructuring in the Asia Pacific region typically covers the following areas:

- Exit tax/ capital gains on conversion;
- Permanent establishment ("PE") issues for the Principal in the local country jurisdiction; and
- Post-restructuring transfer pricing.

Table 1 below shows the level of audit activity surrounding business restructuring in the Asia Pacific region:

### TABLE 1: AUDIT ACTIVITY SURROUNDING BUSINESS RESTRUCTURING IN THE ASIA PACIFIC REGION

| Type of challenge | Audit activity | Country |
|---|---|---|
| Conversion gain | Increasing | Australia, India, China, South Korea, Japan, Indonesia |
| Permanent establishment (PE) | Extensive | India, Thailand, China |
| Post-restructuring Transfer Pricing | Extensive | Australia, India, China, Malaysia, Indonesia, South Korea, Japan, Taiwan |

Tax authorities in the Asia Pacific region frequently challenge business restructurings from a PE perspective as well as from a transfer pricing perspective. Conversion gains are increasingly being scrutinised as well in countries, which impose exit taxes.

## KEY TAX IMPLICATIONS IN UNDERTAKING A BUSINESS RESTRUCTURING IN MALAYSIA

Some of the key tax issues that should be considered in undertaking a business restructuring in Malaysia are as follows:

- **Permanent establishment issues**
  A business restructuring involving the move towards a commissionaire or toll manufacturing arrangement may potentially create a dependent agent permanent establishment (PE) for the Principal in Malaysia. The Principal will be subject to Malaysian income tax if it has a PE in Malaysia. Consequently the use of such structures needs to be carefully managed.

- **Exit charges and capital gains tax**
  If the business restructuring involves a transfer of a business in Malaysia, it is important to analyse the relevant components of the business transferred (e.g. buildings, plant and machinery, inventory, intangibles, etc.) to determine the liability to income tax,

Real Property Gains Tax ("RPGT") and stamp duty. Broadly,

i) Income tax would apply on the sale of inventories. Further, there could be income tax implications arising from the sale of fixed assets on which capital allowances (i.e. tax depreciation) were claimed.
ii) RPGT would apply on the sale or transfer of "real property" in Malaysia, such as landed property in Malaysia or shares in privately held land rich companies (i.e. real property companies).
iii) Stamp duty would apply on the instrument of transfer of "property" such as debtors and goodwill.

Where a payment is made to compensate the Malaysian entity for the removal of an asset (e.g. in converting the full-fledged manufacturer into a toll manufacturer), from an income tax perspective, the sum paid for the transfer of the business should *prima facie* be treated as a capital payment. Such capital payment should not be subject to RPGT in Malaysia, as it does not involve the transfer of any real property.

### Anti-avoidance legislation

Malaysia has in place anti-avoidance legislation (Section 140 of the Income Tax Act 1967 (ITA)), which permits the Malaysian tax authority to disregard or vary any transaction that is believed to have the direct or indirect effect of tax avoidance. Whilst Section 140 has yet to be applied to business restructurings it is nevertheless important from a risk management perspective to ensure that there is a robust and supportable business case for the restructuring.

### Transfer Pricing

Effective 1 January 2009, Section 140A of the ITA requires that transactions with "associated persons" for the acquisition or supply of property or services be entered into on an arm's length basis. Section 140A puts the burden of proof on taxpayers to demonstrate arm's length pricing.

The Income Tax (Transfer Pricing) Rules 2012 (the "Rules") have also been introduced which require taxpayers to prepare contemporaneous documentation defined as transfer pricing documentation which is prepared when a taxpayer implements a related party transaction; or where there are material changes to the related party transaction during a year of assessment, the documentation should be updated prior to the submission of the tax return for that year of assessment.

From a transfer pricing perspective it needs to be ensured that economic substance of the Principal is established and the functions, assets and risks of the local entities in Malaysia are consistent with the business model being proposed.

The stripping away of profits as a result of the redeployment of functions, assets and risks will inevitably attract greater scrutiny from tax authorities in Malaysia who seek to protect their existing tax base.

Therefore, the local entity must be seen to be receiving an arm's length remuneration and appropriate transfer pricing documentation for the new structure must be in place.

This includes documentation of how the arm's length standard has been applied in terms of the initial structure, the new structure and the arm's length payments (if any) that would be expected on converting from one structure to the other.

Additionally, the business rationale for moving people and functions and the expected benefits from the restructuring, including the role of synergies and the options that would have realistically been available to the parties need to be documented as this would go towards supporting the change in business model.

Advanced Pricing Arrangement (APA), which is an agreement between the taxpayer and the tax authorities on the transfer price for future related party transactions, is available in Malaysia to assist companies in managing transfer pricing risks.

### Indirect tax and Customs

Customs and indirect tax issues such as whether there is any impact on preferential duty rates if invoicing is to be performed from the Principal country, issues with drop shipments, issues arising from the storage of goods in Malaysia, etc. need to be addressed.

### Foreign exchange remittance

The foreign exchange administration policies in Malaysia have been progressively liberalised and simplified over the years and should not be an issue in a business restructuring. Non-residents are now free to make payments to, or receive payments from residents in Malaysian Ringgit, as settlement for goods or services transactions with the local Malaysian entities.

In conclusion, in undertaking a business restructuring in Malaysia, it is important that the rationale for the restructuring be documented. This should explain the commercial rationale for the restructure both from a Group perspective and also demonstrate how the Malaysian entity benefits or at least does not lose out from the restructure.

It is also important that there be economic substance in the Principal (i.e. transfer of key personnel to support the Principal structure) and contracts which reflect the changes in the relationships and sharing of risks and modifications to the supply chain should also be in place.

Evidence of arm's-length pricing applied to the restructure itself and the post-restructure arrangements must be documented. Taxpayers are encouraged to use APAs to effectively manage transfer-pricing risks arising from business restructurings in Malaysia. mb

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