

TAX INCENTIVES AND ITS IMPLICATIONS ON INVESTMENT IN MALAYSIA

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This paper touches on two aspects, the first on the general framework of tax incentives currently available and second, on the tax implications on investment in Malaysia.

Tax Incentives

Since independence, the government has realised that to effectively promote industrialisation a necessary environment must be created. With this in mind, in the 1950's, when the Government first launched its first economic plan, the Government allocated \$115.8 million or 2.5% of the total public development expenditure for industrial and mining development. This allocation has steadily increased over the subsequent five year plans and under the Fifth Malaysia Plan (1986 - 1990), \$3,149.65 million or 4.56% of the total public development expenditure during the plan period. A positive step towards accelerating industrial development then was the establishment of industrial estates, with the first one in the new satellite town of Petaling Jaya. At the same time, infrastructure facilities were up graded.

Apart from physical incentives, fiscal incentives, as part and parcel of the overall effort to create a conducive investment climate to attract specific industries, were considered. For this purpose, the Pioneer Industries Ordinance was introduced in 1958 and Malaysia embarked on industrial development based on the promotion of import-substitution industries, such as consumer goods and intermediate goods. To nurture these 'infant' industries, protective tariffs were introduced. This attempt by the Government proved successful and a number of industries were established producing items such as cooking oil, detergents, bricks, cement, building materials and consumer durables.

While the Pioneer Industries ordinance of 1958 was successful in attracting industries, it was inadequate in accommodating the wider objectives of the Government particularly employment creation and income distribution which were necessary if the country was to industrialise rapidly. The limited domestic market, the emphasis on greater processing of domestic raw materials and the

scarcity of domestic capital required foreign capital, management expertise, technical know-how and marketing outlets. A shift in policy to attract foreign investments and export-oriented industries resulted in the Pioneer Industries Ordinance 1958 being repealed and in its place the Investment Incentives Act, 1968 was introduced.

The Investment Incentive Act, 1968

The introduction of the Investment Incentives Act, 1968 saw an increased emphasis being given to labour-intensive industries, export-oriented industries, industries utilising domestic raw materials and the establishment of industries in the less developed areas of the country. Apart from Pioneer Status, new incentives in the Act were the Investment Tax Credit, Export Allowance, Double Deduction of Expenses Incurred on Promotion of Exports Overseas, Accelerated Depreciation Allowance, the Increased Capital Allowance and the Hotel Incentives, comprising the Pioneer Status, Abatement of Income Tax on Chargeable Income, Industrial Building Allowance, Accelerated Depreciation Allowance and the Hotel Tax Credit.

Over the years, these incentives were reviewed and improvements were made in line with development objectives of the Government. For example, in 1971, the Labour Utilisation Relief was introduced as a means to promote labour-intensive industries. In 1972, the Locational Incentive was introduced to achieve a more balanced regional development as the incentives provided for under the Pioneer Status, Labour Utilisation Relief and the Investment Tax Credit were found to be inadequate to achieve the policy of dispersal of industries. To further encourage employment and the establishment of export-oriented industries, a special incentive was introduced in 1973 providing tax relief for periods ranging from 4 to 10 years. Agriculture was given a boost in 1978 with the introduction of the special Incentives for Approved Agricultural Industries.

Thus it was necessary to review and rationalise the various incentives and streamline its administration. This led to the promulgation of the Promotion of Investments Act, 1986 which is currently the main legislation for fiscal incentives for manufacturing, agriculture and tourism in Malaysia.

The Promotion of Investments Act, 1986

The Promotion of Investments Act 1986 provides for the development of the manufacturing, agricultural and tourist sectors. With the introduction of this Act, the Investment Incentives Act, 1968 was repealed.

The tax incentives provided for under the Promotion of Investments Act, 1986 are as follows: —

- (a) Pioneer Status
- (b) Investment Tax Allowance
- (c) Abatement of Adjusted Income
- (d) Export Allowance
- (e) Double Deduction for Promotion of Exports
- (f) Industrial Building Allowance for Hotels

The Pioneer Status Incentive is available to companies which intend to participate in 'promoted activities' or which intend to produce 'promoted products'. The list of 'promoted activities' and 'promoted products' is published by statutory order in government Gazette from time to time. In determining the products and activities, the following factors are taken into consideration: —

- (a) Whether or not the activity is being carried on or the product is being produced on a commercial scale suitable to the economic requirements or development of Malaysia or at all;
- (b) Whether there are:—
 - (i) favourable prospects for further development of the activity or product; or
 - (ii) insufficient facilities in Malaysia to enable the activity to be carried on or the product to be produced on a commercial scale suitable to the economic requirements; or
- (c) The national and strategic requirements of Malaysia.

A company granted pioneer status must, within 6 months from the date of such grant or such extended period, request for a pioneer certificate specifying among others, the date the factory commenced production of the promoted product in marketable quantities. The pioneer certificate granted to the company will specify the production

day from which date the tax relief will start for a period of 5 years, irrespective of the level of capital investment. The tax relief period of a pioneer company carrying on a manufacturing activity can be extended by an additional 5 years if the company produces specific promoted products or engages in specific promoted activities and it fulfils any of the following criteria:—

- (a) the pioneer company must have incurred a capital expenditure (excluding land) of at least \$25 million by the end of the initial 5 years of tax relief; or
- (b) the Pioneer company must have employed at least 500 fulltime paid Malaysian employees by the end of the initial 5 years of tax relief; or
- (c) the pioneer company, in the opinion of the Minister will promote or enhance the economic and technological development of Malaysian line with the Government policy relating thereto.

Dividends paid out of tax exempt income will be exempted from tax in the hands of shareholders.

A pioneer company is entitled to the initial allowance and annual allowance on qualifying capital expenditure incurred during the tax relief period may be carried forward and treated as capital expenditure incurred on the day following the end of the tax relief period. A pioneer company can carry forward any unabsorbed capital allowance from the pre-pioneer period into the post-pioneer period.

Companies producing 'promoted products' or engaged in 'promoted activities' are eligible to apply for the Investment Tax Allowance (ITA) as an alternative to the Pioneer Status. The maximum amount of allowance that can be granted under the ITA is 100%. It is given for the year of assessment in the basic period in respect of expenditure incurred within five years from the date of approval. For integrated expenditure projects, in respect of the manufacturing activity, expenditure incurred within another period of 5 years from a date determined by the Minister of Trade and Industry, being a date within or after the first 5 years, is also eligible for the ITA. The criteria and rates for the granting of the ITA for the manufacturing, agricultural and tourist sectors were announced in 1987 to assist investors in their decision to invest in the country.

Where the ITA is given to a company for a year of assessment, so much of the adjusted income of the company for the bases period for that year is equal to the amount of the allowance shall be exempted from tax for the year

of assessment. Where effect cannot be given or cannot be given in full to any allowance which the company is entitled to, then, so much of the allowance in question that cannot be given for the year shall be deemed to be an allowance to be given to the company for the first subsequent year of assessment for the basis period for which there is adjusted income from that business and so on for subsequent years of assessment until the company has received the whole of the allowance to which it is entitled.

Dividends paid out from exempted income are exempted from tax in the hands of shareholders.

A new incentive introduced under the Act is the abatement of adjusted income. The incentive is aimed at encouraging the exports of locally manufactured products, the development of 'promoted industrial areas', the development of 'small-scale industries' and compliance with Government policy on equity participation and employment in industries.

Under the abatement of adjusted income for exports, where a resident company exports directly or through agents any product manufactured by the company in Malaysia, the adjusted income of the company for that year of assessment can be abated at the rates stipulated below:—

- (a) a rate which is equivalent to 50% of export sales to total sales;
- (b) 5% of the value of indigenous Malaysian materials which are incorporated in the manufacture of products exported.

In the case of the abatement of adjusted income for location, resident manufacturing companies which have factories in operation in 'promoted industrial areas' as gazetted by the Minister of Trade and Industry will qualify for an abatement of 5% of the adjusted income of its manufacturing activity. This incentive is given for a minimum of 5 consecutive years, notwithstanding that the declaration of the 'promoted industrial area' is revoked by the Minister of Trade and Industry.

Under the abatement of adjusted income for small-scale industries 'resident small-scale manufacturing companies' are eligible for an abatement of 5% of the adjusted income from the year of assessment in the basis period on which the business commences. For this purpose, a 'small-scale' manufacturing company is defined as one whose shareholder's funds is not more than M\$500,000.

An abatement of adjusted income is granted to resident manufacturing companies which comply with the Government's policies on capital participation or employment in industry on or after 1.1.1986.

Dividends paid out of tax exempted income under abatement of adjusted income are exempted from tax in the hands of shareholders.

An export allowance equivalent to 5% of the f.o.b. value of export sales will be granted to encourage the export of agricultural produce. It is also available to trade companies which export products manufactured in Malaysia.

To encourage local industrialists to seek opportunities for the export of products manufactured in Malaysia, the Government provides incentives in the form of double deduction of these expenses incurred. Expenses that qualify are expenses incurred on overseas advertising; supply of free samples abroad; export market research; preparation of tenders for supply of goods overseas; supply of technical information abroad; public relations work connected with exports; exhibits and/or participation required in trade or industrial exhibitions approved by the Minister of Trade and Industry; fares in respect of travel overseas by employees of companies for business; accommodation and sustenance expenses incurred by Malaysian businessmen going overseas for business subject to \$200 per day and cost of maintaining sales office overseas for the promotion of exports.

The incentive is available to all resident companies and in the case of pioneer companies, the deductions are accumulated and allowed against their post-pioneer income.

The Industrial Building Allowance (IBA) for hotels consists of an initial allowance of 10% and an annual allowance of 2%. It is given to a pioneer company or a company granted pioneer status or investment tax allowance which has incurred capital expenditure on an approved hotel building or in extending or modernising an existing hotel to the approved standard.

The Income Tax Act, 1967

In addition, a number of other incentives are provided under the Income tax Act, 1967 to encourage investments in the various sectors.

The Accelerated Depreciation Allowance has been extended up to year of assessment 1989. Qualifying capital expenditure incurred up to 31.12.1988 would be eligible for this incentive. The incentive is in the form of an initial allowance of 20% and annual allowance of 40%. This means that total capital

expenditure can be written off within two years. The objective of this incentive is to encourage industries to modernise and expand.

The Reinvestment Allowance has been extended up to year of assessment 1991. Under this incentive, all existing companies engaged in manufacturing and processing which are not enjoying the Pioneer Status, Investment Tax Credit/Investment Tax Allowance, Labour Utilisation Relief, Locational Incentive or the Accelerated Depreciation Allowance under the Investment Incentives Act, 1968, Promotion of Investments Act, 1986 and the Income Tax Act 1967 are eligible to apply for the Reinvestment Allowance. The incentive is in the form of an allowance of 40% of the expenditure on plant, machinery and industrial building incurred on or after 1.1.1988 till 31.12.1990 for expansion purposes. For capital expenditure on plant, machinery and industrial buildings.

To encourage exporters to penetrate into non-traditional markets, premium payment on export credit insurance insured with a company approved by the Ministry of Finance are eligible for double deduction with effect from year of assessment 1986.

Buildings used as warehouses and as bulk storage installations used for storing goods for export are eligible for Industrial Building Allowance consisting of an initial allowance of 10% and an annual allowance of 28%.

Being aware of the importance of research and development, the Government further improved the incentives for R&D as follows:—

- (a) Expenses of a revenue nature incurred on scientific research by a person, which is related to his business and directly undertaken by him or on his behalf, is eligible for single deduction. Where the research is approved by the Minister of Finance, the revenue expenditure is eligible for double deduction.
- (b) Industrial building allowance in the form of an initial allowance of 10% and an annual allowance of 2% is available for buildings used for purposes of approved research notwithstanding that the research is not related to the business.
- (c) Plant and machinery used for purposes of approved research are eligible for capital allowances, notwithstanding that the research is not related to that business.

In order to upgrade skills and improve productivity, incentives are also given to encourage the private sector to undertake industrial training. An industrial building allowance, consisting of an initial allowance of 10% and an annual allowance of 2% is given to companies which have incurred expenditure on building used for approved industrial training. In addition, double deduction of operational expenses is granted to manufacturing companies that have incurred for approved training.

Under the Agriculture Allowance, capital expenditure in agricultural activities are eligible for deduction as follows:—

- (a) Expenditure incurred on the clearing and preparation of land, planting of crops and construction of roads for purposes of agriculture is eligible for a yearly allowance of 50% of the expenditure incurred.
- (b) Expenditure incurred on construction of a building for the welfare of persons or as living accommodation for a person can be written off at a rate of 20% per annum.
- (c) Expenditure incurred on the construction of any other buildings used for purposes of working the farm can be written off over a period of 10 years, that is at the rate of 10% per annum.

As long as the above qualifying expenditures are incurred, the allowance will be given, irrespective of whether the companies have been granted the Pioneer Status or the Investment Tax Allowance.

To further encourage tourism, tour operators who bring in at least 500 foreign tourists each through group inclusive tours are exempted from tax in respect of the income derived from the business of operating such tours. This incentive which is effective for the years of assessment 1986 to 1990 inclusive, is given to operators who are registered and approved by the Tourist Development Corporation.

Apart from the incentives under the Promotion of Investments Act, 1986 and the Income Tax Act 1967, exporters can avail themselves of the Export Credit Refinancing (ECR) facility implemented by Bank Negara and Central Bank, to promote the growth of exports of Malaysian manufactured goods. The ECR provides Malaysian exporters with credit at preferential rates of interest to enable them to compete more effectively in international markets. All products with domestic value-added of at least 20% and which use a minimum of 30% of local raw materials except those in the 'negative list' are eligible for this facility.

Under this scheme, Bank Negara undertakes to refinance for a maximum period of four months in the case of pre-shipment and six months in the case of post-shipment, credit extended by the commercial banks to exporters of goods manufactured in Malaysia. The current maximum interest rate for exporters under the facility is 4% per annum.

The maximum amount of refinancing for each firm is \$5 million but higher limits may be given on a case-by-case basis, upon application to Bank Negara. The minimum amount for refinancing, that is, the minimum value of each substitution bill, is \$20,000 expressed to the nearest thousand ringgit. Exporters can 'bunch' several smaller bills to make \$20,000.

Beside the above-mentioned investment incentives, manufacturing companies are also eligible to apply for other types of fiscal incentives, such as tariff protection and import duty exemption. Tariff protection is generally provided to industries, the products of which are facing stiff competition although their qualities and prices are acceptable.

Implications

In 1987, the proposed foreign equity for new projects and expansion jumped by about 43% against 1986, from \$524.5 million to \$750.0 million. For various reasons, both Bumiputera and Non-Bumiputera equity declined. Could incentives be one of the major influences? Let us examine the following points.

1. It is important to note that numerous studies on foreign investment incentives conclude that the tax holidays are not a major influence on investment location decisions by most foreign investors. This is true because of the uncertainty and risk of the project's ultimate profitability, and the uncertain tenure of the tax regime. More over, the ability of many foreign investors to benefit from tax incentives is limited by home country taxation policies such as in the United States and Japan. Income tax concessions may have a greater impact on the decisions of investors in export-oriented projects seeking the lowest cost locations. Overall, however, it would probably be accurate to say that foreign investors are far more likely to focus on the factors affecting their ability to make profits, for example management control, proper staffing, economic stability, domestic cost structures, and availability of cheap raw materials.
2. The first wave of investments swept Malaysia in the early 1970's with the establishment of American electronic companies like Intel, Motorola, and Texas Instruments. The current influx of investments known as the

second wave, predominantly characterised by the rush to establish dipped latex goods factories in the country, is in fact more due to factors other than incentives. These factors are the high production costs at home caused by rising labour costs and the appreciation of currencies against the US dollar which has urged foreign investors from Japan, Taiwan and South Korea to relocate their factories. The weak Malaysian Ringgit and better market access through the General System of Preferences which benefits Malaysia is another case in point.

3. The statistics reflect that domestic investments has declined in recent years. This is, however, misleading for the statistics compiled do not reflect the whole picture anymore. A third amendment was already made to the Industrial Coordination Act, 1975. Since October, 1986, the licensing exemption limit was raised to shareholder's funds of \$2.5 million and 75 workers from the previous limit of \$1.0 million and 50 full-time workers. As a result of this, 70% of companies that used to be licensed do not have to comply anymore and their activities therefore not recorded by MIDA.
4. Finally, is appropriate to stress that the gap between foreign and domestic investments could also be due to the slow response from local investors in picking-up with the overseas markets because most of them were operating below the normal production capacities in past years. In spite of the new licensing concession that frees them from the time-consuming red tape of getting licences and meeting with the NEP guidelines, they were slow to respond because when the economy picks up, they had to tap their existing excess capacities.