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## EY Tax Alert (Special Edition)

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# Guidelines on determining whether a “place of business” exists in Malaysia in the absence of a tax treaty

### Coverage of this Alert

- Scope of derivation of business income
- Application of Sections 12(3) and 12(4) of the ITA


Section 12 of the Income Tax Act 1967 (ITA) sets out the circumstances under which business income would be derived from, and hence taxable in, Malaysia. For a non-resident, Section 12 would apply if the non-resident is from a country which has not entered into a tax treaty with Malaysia.

Sections 12(3) and 12(4) were introduced into the ITA via the Finance Act 2018, to supplement Section 12 (see Special Tax Alert: Highlights of 2019 Budget – Part II). These provisions were effective from 28 December 2018.

Section 12(3) provides that the business income of a person that is attributable to a “place of business” in Malaysia is deemed to be derived from Malaysia. Section 12(4) clarifies the meaning, and provides examples, of what constitutes a place of business.

The Inland Revenue Board (IRB) has now issued on its website guidelines dated 21 May 2020, titled “Guidelines on the application of Subsections 12(3) and 12(4) of the Income Tax Act 1967 in determining a “Place of Business”” (Guidelines) in relation to the above-mentioned provisions. Nine (9) examples have also been provided in the Guidelines.

Some of the key points are outlined below.



## Scope of derivation of business income

Sections 12(3) and 12(4) were intended to supplement, and not override or limit, the widely worded existing provisions in Section 12 of the ITA. Section 12 generally provides that gross income from a business that is not attributable to operations carried on outside Malaysia, shall be deemed to be derived from Malaysia. Specific rules apply to companies in the business of manufacturing, growing, mining, producing or harvesting in Malaysia.

In cases where it is unclear whether business operations are carried on in Malaysia, the Guidelines stipulate that as long as it is established that a “place of business” exists under Sections 12(3) and 12(4) of the ITA, income attributable to the “place of business” is derived from Malaysia.

The Guidelines reiterate that where a non-resident is a tax resident in a country which has concluded a tax treaty with Malaysia, the provisions of the treaty would prevail. In such a case, the business income of the non-resident should not be taxable in Malaysia unless it is attributable to a permanent establishment (PE) of the non-resident, in Malaysia<sup>1</sup>.

## Application of Sections 12(3) and 12(4) of the ITA

The Guidelines provide guidance on the determination of the existence of a “place of business” under the following categories:

- i. Physical “place of business”
- ii. Preparatory or auxiliary activities
- iii. Building site, construction, installation, assembly and supervisory activities
- iv. Agent as “place of business”

### Physical “place of business”

As highlighted earlier, Section 12(4) clarifies the meaning of a “place of business”. Section 12(4) is however non-exhaustive and includes any premise, facility or installation used to carry on the person's business, whether used exclusively for that purpose or not.

The Guidelines also stipulate that a “place of business” may exist in cases where a person simply has a certain amount of space at his disposal. Whether or not a person has a physical place at his disposal would depend on

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<sup>1</sup> Note that the MIRB takes the position that service income of a non-resident and income of a non-resident from the use of movable property are “special classes of income”. Such income may be subject to withholding tax even in the absence of a Malaysian PE.

the person's access to use that physical space, the extent of presence and the activities performed in that space. These concepts are similar to the Organisation for Economic Co-operation and Development (OECD)'s guidance in the commentary on the PE provisions of the OECD model tax treaty.

The Guidelines state that the "place of business" must be fixed. The two critical considerations are as follows:

- i. Degree of permanence at a geographical point (i.e. the duration test)  
A "place of business" is deemed to exist only if the physical place has a certain degree of permanency. Unfortunately, the Guidelines do not suggest a prescribed duration that would cause a fixed place of business to exist. In fact, the Guidelines stipulate that a physical place may constitute a place of business "even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time".
- ii. Specific geographical point (i.e. the location test)  
The "place of business" must be fixed. However, in situations where business activities are conducted in multiple locations, the determination of a single "place of business" will be based on geographical or commercial coherence.

#### Preparatory or auxiliary activities

The Guidelines stipulate that where a physical place is maintained solely for the purpose of carrying on activities which are of preparatory or auxiliary character, such place would not constitute a "place of business". This is generally in line with the PE Article in tax treaties.

The Guidelines explain that preparatory or auxiliary activities would usually have the following characteristics:

- (a) The activities are so remote from the actual realization of profit of the business that it is difficult to allocate any profit to the physical place in question;
- (b) The activities do not form an essential and significant part of the business as a whole;
- (c) The activities are not identical to the general purpose of the whole business; or
- (d) The activities are usually carried out for a relatively short period of time.

However, where multiple activities are undertaken in Malaysia, these activities need to be considered holistically to assess whether the overall nature of the activities is still preparatory or auxiliary in nature. If the combination of various preparatory or auxiliary activities constitutes part of a cohesive business operation, the individual activities would not be regarded as preparatory or auxiliary.

#### Building site, construction, installation, assembly and supervisory activities

The Guidelines stipulate that for a building site, or construction, installation or assembly project, or supervisory activities in connection with such projects, a person will be deemed to have a "place of business" if the person carries on activities at the site or project for a period or periods exceeding an aggregate of five (5) months in

any 12-month period. The duration includes the period of activities carried on by the person and his associated persons in Malaysia, where the activities carried out by the parties are connected.

The Guidelines do not cover the “fixed place of business” implications of other service activities other than building, construction, installation, assembly and supervisory activities.

To determine whether activities carried out are connected, the factors to be considered include the following: -

- (a) Whether the contracts covering the different activities were concluded with the same person or his associated persons;
- (b) Whether the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with the person or his associated persons;
- (c) Whether the activities would have been covered by a single contract, if not for tax planning considerations
- (d) Whether the nature of work under the different contracts is the same or similar;
- (e) Whether the same employees are performing the activities under different contracts

The Guidelines also provide guidance on the withholding tax treatment of payments for services performed in Malaysia.

#### Agent as “place of business”

The Guidelines stipulate that a person (principal) may be deemed to have a “place of business” in Malaysia if the person has another person acting on his behalf (agent) who:

- (a) Habitually concludes contracts\*;
- (b) Habitually plays the principal role leading to the conclusion of contracts\* that are routinely concluded without material modification;
- (c) Habitually maintains a stock of goods or merchandise in that place of business of the person, from which such person delivers goods or merchandise; or
- (d) Regularly fills orders on behalf of the person

\*These include contracts concluded in the principal's name, or which are binding on the principal even though the contracts are not in the principal's name.

For points (c) and (d) above, a non-resident will be deemed to have a “place of business” if the agent conducts sales-related activities in addition to regularly delivering or filling orders out of the stock of goods or merchandise belonging to the principal – which suggests that mere delivery by an agent may not in itself be tantamount to a place of business.

The Guidelines clarify that independent agents who act for a foreign enterprise in the ordinary course of their (i.e. the agents') business should not result in a place of business being created in Malaysia for the foreign enterprise. However, a person would not be considered an independent agent if he acts exclusively, or almost exclusively, for one or more associated persons.

## Toll manufacturing example

Example 9 of the Guidelines discusses a non-resident company that has appointed a Malaysian related company to provide toll manufacturing services and warehousing facilities. The non-resident owns raw materials and finished products in Malaysia and also undertakes marketing activities in Malaysia. The Guidelines conclude that the overall nature of the activities undertaken in Malaysia leads to the conclusion that the non-resident company has a place of business in Malaysia.

The fact pattern set out in Example 9 is not uncommon in toll manufacturing arrangements. As such, the impact of the example should be carefully assessed by non-residents that have appointed toll-manufacturers in Malaysia, especially if no treaty protection is available and where the toll manufacturers are related to the non-resident.

Example 9 is replicated in the Appendix to this Tax Alert.

The Guidelines are available at the following link:

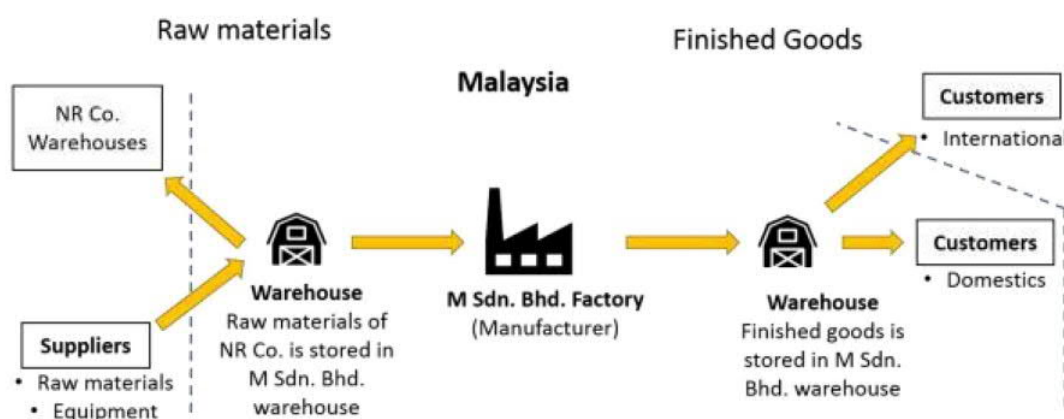
[http://lampiran1.hasil.gov.my/pdf/pdfam/GP\\_21052020\\_2.pdf](http://lampiran1.hasil.gov.my/pdf/pdfam/GP_21052020_2.pdf)

## Example 9

## Business model of NR Co.:

- (i) NR Co. in country C is the principal and ultimate holding company of M Sdn Bhd. M Sdn Bhd acts as a toll manufacturer and also provides warehousing facilities to NR Co. in Malaysia. M Sdn Bhd receives fees for toll manufacturing, warehousing, storing and delivery of services from NR Co.
- (ii) NR Co. owns the products throughout the entire manufacturing and distribution process. All marketing, sales and distribution functions are conducted by NR Co. It has a sales representative office in Malaysia; however, the activity is limited to marketing to new or existing customers and is not authorized to sign contracts.
- (iii) M Sdn Bhd owns and manages two warehouses:
  - A private bonded warehouse for the storage of raw materials belonging to NR Co. The warehouse also delivers raw materials to other manufacturers outside Malaysia.
  - A private bonded warehouse for the storage of finished goods belonging to NR Co. The warehouse also stores finished goods received from other toll manufacturers outside Malaysia.
- (iv) Personnel of NR Co. are not involved in the warehouse operations and do not have unrestricted access to the warehouses.
- (v) The warehouses only execute orders at the request of NR Co. Upon receiving an order, the finished goods will be shipped to customers within or outside Malaysia. The warehouses in Malaysia also support regional returned shipments and warranty replacement programs for regional customers.

## Business flow: Malaysia integrated warehouse



The warehouses are not at the disposal of NR Co. Therefore, these places of business by themselves do not constitute a “place of business” to NR Co. However, the overall activities of NR Co. in Malaysia – including the warehousing activity, the manufacturing of goods as well as the marketing activity of the sales representative office – constitute complementary functions that are part of a cohesive business operation. Consequently, NR Co. would have a place of business in Malaysia.

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