Building a better working world

EY Tax Alert

Vol. 26 – Issue no. 13
3 August 2023

Malaysian developments

Madani Economy: Empowering the People

On 27 July 2023, Prime Minister and Finance Minister Datuk Seri Anwar Ibrahim launched the "*Madani* Economy: Empowering the People" economic framework. The two main focuses of the framework are to restructure the economy to make Malaysia a leader among Asian economies and to ensure that the enlarged wealth is benefitted equitably by the *Rakyat*. The *Madani* Economy framework will serve as a foundation for other policies, such as the National Energy Transition Roadmap, the New Industrial Masterplan 2030 and the Mid-Term Review of the 12th Malaysia Plan.

The *Madani* Economy framework sets short-term targets and medium-term targets that will be achieved in the next ten years:

- **Short-term targets**
  a) To accelerate the implementation of projects relating to schools and dilapidated clinics
  b) To eradicate hardcore poverty this year

- **Medium-term targets**
  a) To rank Malaysia among the top 30 largest economies in the world
  b) To rank Malaysia among the top 12 countries in the world in the Global Competitiveness Index
  c) To increase the percentage of labour income to 45% of total income
  d) To increase the female labour force participation rate to 60%
  e) To rank Malaysia among the top 25 countries in the world in the Human Development Index
  f) To improve Malaysia's position in the Corruption Perceptions Index to being among the top 25 countries in the world
  g) To achieve fiscal sustainability with a fiscal deficit of 3%, or lower

Below are some of the tax measures or initiatives which were announced or reiterated to help the country achieve the targets:

Focus 1: Malaysia as a leader among Asian economies

- To introduce outcome-based tax incentives that focus on high-impact activities
- To review the investment incentives to be more focused on generating high-income jobs
- To reduce the stamp duty on contract notes for the trading of listed shares or stocks (effective for contract notes executed from 13 July 2023 to 12 July 2028, see *Tax Alert No. 12/2023*)
- To promote specific incentives to encourage new green growth activities such as Sarawak's bus project that utilises hydrogen energy and Carbon Capture, Utilisation and Storage (CCUS)

Focus 2: Elevating the quality of the *Rakyat's* life

- To strengthen the development of *Iskandar Malaysia* in Johor by providing special tax incentives, a concessionary 15% tax rate for knowledge workers and fast-track immigration facilities
- To offer more incentives and tax services for the social enterprise sector

e-Invoice Guideline

Further to the announcement of the Government's implementation of electronic invoicing in 2024, the Inland Revenue Board (IRB) published on its website the e-Invoice Guideline (Version 1.0) (Guideline) on 21 July 2023.

The Guideline comprises the following paragraphs:

1.0 Introduction
2.0 Getting ready for e-Invoice
3.0 Data security and privacy monitoring by IRBM
4.0 Assessing readiness of e-Invoice

The Guideline also lists the data fields (mandatory and optional) required for an e-Invoice and its annexure, as well as Frequently Asked Questions (FAQs) that taxpayers may have regarding e-Invoice.

The Guideline describes two distinct e-Invoice transmission mechanisms, i.e., a portal hosted by the IRB (MyInvois Portal) and Application Programming Interface (API).

e-Invoice will be implemented in phases, based on the turnover or revenue thresholds of businesses. The e-Invoice implementation timeline is as follows:

Timeline	Targeted taxpayers
1 June 2024	Taxpayers with annual turnover or revenue of more than RM100 million
1 January 2025	Taxpayers with annual turnover or revenue of more than RM50 million and up to RM100 million
1 January 2026	Taxpayers with annual turnover or revenue of more than RM25 million and up to RM50 million
1 January 2027	All taxpayers and certain non-business transactions

For more details, please see *Take 5: e-Invoice Guideline: Navigating the future of tax digitalization*.

Updated technical guidelines on the tax treatment of research and development (R&D) expenditure

The IRB has published on its website the Guidelines on the Application Procedure for a Special Deduction in respect of a Qualifying R&D Activity (Technical Guidelines), dated 26 June 2023. The new 16-page Technical Guidelines replace the earlier Technical Guidelines, which were issued on 29 December 2021 (see *Tax Alert No. 1/2022*). The new Technical Guidelines explains the application procedure for an approved qualifying R&D activity that qualifies for a special deduction under Section 34A of the Income Tax Act 1967 (ITA), and the requirement to submit the relevant forms when a claim is made for deductions under Sections 34(7), 34A or 34B of the ITA. The Guidelines are similar to the earlier 2021 Guidelines and were updated to incorporate the revised application forms – see Paragraph 4.1 of the Technical Guidelines.

Remission of tax and stamp duty

The Loans Guarantee (Bodies Corporate) (Remission of Tax and Stamp Duty) (No. 2) Order 2023 [P.U.(A) 216] was gazetted on 18 July 2023. The Order provides that any tax payable under the ITA and any stamp duty payable under the Stamp Act 1949 in relation to the following shall be remitted in full:

(a) Syndicated Islamic Revolving Credit Facility obtained or will be obtained by Tenaga Nasional Berhad from CIMB Islamic Bank Berhad and Maybank Islamic Berhad (RC-i Facility); and
(b) Guarantee provided by the Government of Malaysia in relation the RC-i Facility

The Order came into operation on 19 July 2023.

Further extension of time (EOT) for the submission of YA 2023 tax returns under the Labuan Business Activity Tax Act 1990 (LBATA)

The IRB's Labuan branch has granted further EOT for submission of tax returns under Sections 5 and 10 of the LBATA for YA 2023 (based on the financial year ended in 2022) via its letter dated 26 July 2023 to the Association of Labuan Trust Companies (ALTC). The submission deadline of the tax returns for YA 2023 has been extended from 31 July 2023 (see *Tax Alert No. 6/2023*) to **30 October 2023**.

The IRB reiterated that they are in the process of digitalizing the LBATA tax filing, with full digitalization expected by 2025. To facilitate the process, Labuan entities are required to submit a scanned copy of the relevant documents such as the Form LEs and audited accounts, together with the hard copies, to the IRB's Labuan International Section from YA 2023 onwards.

Overseas developments

OECD/G20 Inclusive Framework releases Subject to Tax Rule model treaty provision and commentary

Among the series of documents that the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework released on 17 July 2023 focusing on elements of the OECD/G20 project on addressing the tax challenges of the digitalization of the economy (the BEPS 2.0 project), is a document under Pillar Two containing the model treaty provision of the Subject to Tax Rule (STTR), together with an accompanying commentary explaining the purpose and operation of the STTR.

Like the Global Anti-Base Erosion (GloBE) Rules, the STTR is an integral part of Pillar Two. The STTR is a treaty-based rule that applies to intragroup payments from source jurisdictions (i.e., the jurisdiction in which the income arises) that are subject to tax rates below 9% in the payee's jurisdiction of residence. The STTR allocates to the source country a limited and conditional taxing right to ensure a minimum level of taxation. The relevant tax rate under the STTR generally is the statutory tax rate applicable in the jurisdiction where the related person deriving the income is a resident, subject to special rules that apply if the person benefits from a preferential adjustment in respect of the income.

The STTR applies to interest, royalties and a defined set of other payments made between connected companies, including all intra-group service payments. Application of the STTR is subject to a series of exclusions and the so-called mark-up and materiality thresholds. The STTR also includes an anti-avoidance rule that targets particular situations, including using back-to-back payments or interposing a connected person that is subject to a tax rate above 9%. Coordination rules provide that taxing rights under the STTR take precedence over tax treaty provisions on the elimination of double taxation.

The STTR document reiterates that the STTR takes priority over the GloBE Rules, so that the application of the STTR does not take into account a qualified Income Inclusion Rule (IIR), qualified Undertaxed Profits Rule (UTPR) or a Qualified Domestic Minimum Top-up Tax (QDMTT). It also reiterates that Inclusive Framework member jurisdictions with nominal corporate income tax rates below the 9% STTR rate have committed to implementing the STTR into their bilateral treaties with other members that are developing countries, if and when they are asked to do so. A multilateral instrument to facilitate implementation of the STTR in relevant bilateral tax treaties will be open for signature from 2 October 2023.

Detailed discussion

Background

The Pillar Two Blueprint, released by the OECD in October 2020, included a description of the STTR framework for developing a treaty-based rule targeting the risks to source jurisdictions posed by BEPS structures involving intragroup payments that take advantage of low nominal tax rates in other contracting jurisdictions.

In October 2021, the OECD released a statement reflecting the high-level agreement of member jurisdictions of the OECD/G20 Inclusive Framework on core design elements of Pillars One and Two of the BEPS 2.0 project. The agreement included a commitment that Inclusive Framework members that apply nominal corporate income tax rates below 9% to interest, royalties and a defined set of other payments would incorporate the STTR into their bilateral treaties with developing Inclusive Framework members when requested to do so.

On 12 July 2023, the OECD released an outcome statement reflecting the agreement reached by 138 of the 143 Inclusive Framework-member jurisdictions on the remaining elements of the BEPS 2.0 project. The July 2023 statement referenced new Inclusive Framework deliverables in several areas, including the STTR under Pillar Two.

Subject to Tax Rule

The STTR document, which contains the model treaty provision for implementing the STTR along with explanatory commentary, reiterates the STTR's importance to developing countries that are Inclusive Framework members. Pillar Two provides jurisdictions with a right to "tax back" where other jurisdictions have not exercised their primary taxing rights or an amount is otherwise subject to low levels of taxation. The document describes the STTR as designed to help developing countries, particularly those with lower administrative capacities, protect their tax bases.

The STTR allows source jurisdictions to tax back where defined categories of intra-group payments are subject to nominal corporate income tax rates below 9% and domestic taxing rights over that income have been ceded under a treaty. The STTR takes priority over the GloBE Rules and therefore application of the STTR does not take into account a qualified IIR, qualified UTPR or QDMTT.

The STTR document includes a model treaty provision and commentary on the STTR, together with related amendments and commentary to model treaty provisions on eliminating double taxation and an annex with examples illustrating the STTR's targeted anti-avoidance rule.

Scope

The STTR covers payments between "connected persons." Two entities will be connected if both entities are under the control of the same person (or persons) either legally (direct or indirect ownership of more than 50% of the interests in the parties) or as a matter of fact and circumstance.

However, the STTR is subject to exceptions, providing that the STTR does not apply if the payment recipient is:

- An individual
- A recognized pension fund
- A specified nonprofit organization
- A State (or a political subdivision or local authority), a central bank, or an agency or entity established by, or any other person wholly or almost wholly owned by a State (or a political subdivision or local authority), provided its principal purpose is to fulfill a government function and it does not carry on a trade or business
- An international organization
- An investment fund that meets specified conditions
- An entity that is subject to a single level of taxation and meets specified conditions
- An entity that is wholly or almost wholly owned by an excluded recipient that meets specified conditions

The STTR includes a "targeted anti-avoidance rule" intended to prevent the use of intermediaries to avoid the STTR, such as interposing an unconnected person between two connected persons or routing a payment through a high-tax connected person. The STTR provision lays out a series of cumulative conditions that must be met for an arrangement to be subject to the rule:

- The payment of the covered income (the original payment) must be made to a person (an intermediary) that is a resident of either of the contracting states.
- The intermediary, during a period of 365 days, directly or indirectly makes payments equal to most or all of the original payment (related payments), meeting three requirements:

  a) Connected payee: The related payment is made to a person (a connected payee) that is connected to the person making the original payment and is not a person excluded from the STTR.

b) Tax rate of connected payee and intermediary: The connected payee is subject to a tax rate below 9% in the jurisdiction where it is a resident and the statutory tax rate in the intermediary's country of residence is also below 9% (taking into account any reduction under a tax treaty).

c) Deductibility of related payments: If the intermediary includes the original payment in its taxable income in its residence country, the related payments it makes to the connected payee are deductible in computing its taxable income in that country.

- It is reasonable to conclude that the related payments would not have been made in the absence of the original payment.

The STTR document provides examples illustrating the operation of the targeted anti-avoidance rule.

<u>Interaction with other articles of the tax treaty</u>
The STTR would not apply if other provisions of the relevant tax treaty already allow the source country to tax the item of covered income at a rate that is equal to or above 9%. However, where an item of income is taxed below 9% under another provision of the relevant tax treaty, the STTR allows a supplementary taxing right to bring the combined rate under the two provisions up to 9%.

<u>Covered income</u>
The STTR applies with respect to the following categories of "covered income":

- Interest
- Royalties
- Payments for distribution rights for a product or service
- Insurance or reinsurance premiums
- Fees to provide a financial guarantee or financing fees
- Rental payments for industrial, commercial or scientific equipment
- Income received for the provision of services

However, the STTR only applies to covered income (other than interest and royalties) if the amount of covered income exceeds the costs (both direct and indirect) incurred in earning that income plus a mark-up of 8.5% on those costs (the mark-up threshold). To calculate the costs associated with a specific item of covered income, the recipient of that income can refer to reliable business records, such as financial statements or internal accounting records. Further, payments of the same category of covered income are aggregated to determine the mark-up on costs if the payments are made under the terms of a single contractual arrangement or are so interrelated that an aggregate analysis is more reliable. Special rules apply for applying the mark-up threshold to income received for the provision of services.

The STTR also includes a "materiality threshold." This means that the STTR applies only if the gross amount of the payee's covered income during a fiscal year exceeds EUR 1 million. However, in situations where the smaller of the two jurisdictions incorporating the STTR into their bilateral tax treaty has a Gross Domestic Product (GDP) below EUR 40 billion, the materiality threshold is EUR 250,000.

<u>Tax rate</u>
Unlike the GloBE Rules that rely on effective tax rate, the starting point for the STTR is the statutory tax rate applicable to an item of covered income. The statutory rate generally means the corporate income tax rate applicable to companies that are resident in the relevant jurisdiction.

The definition of tax rate is based on the assumption that the person deriving the covered income will be subject to tax on net income in the jurisdiction where it is resident. However, there may be cases where relevant taxes are imposed on a different basis. In that case, the Commentary indicates that the two jurisdictions need to agree on the tax rate or a methodology for determining the rate for purposes of the STTR.

The Commentary also indicates that there may be scenarios in which special statutory rates that differ from the general corporate income tax rate in the relevant jurisdiction apply to certain categories of income or to taxpayers with certain characteristics or meeting certain conditions. In these instances, the special rate is used for purposes of the STTR.

Where a person benefits from a "preferential adjustment" to an item of a covered income, the tax rate for purposes of the STTR is calculated after taking into account the effect of the preferential adjustment. A preferential adjustment is a permanent reduction in the amount of the covered income subject to tax or the tax payable on that income in the form of (i) a full or partial exemption or exclusion from income, or (ii) a deduction from the tax base or a tax credit (excluding a credit for foreign taxes paid) that is directly linked to the item of covered income or that arises under a regime that provides a tax preference for income from geographically mobile activities.

The competent authorities of the two jurisdictions must notify one another in writing of the statutory rates and provisions that may result in a preferential adjustment that apply to items of covered income of residents and that are relevant to the STTR

Administration

Taxes imposed under the STTR are determined and levied after the end of the fiscal year in which they arise (i.e., an ex-post annualized charge). The Commentary indicates that this is intended to ensure that all information needed to determine whether the STTR applies to a payment is known before any tax is determined under the STTR.

The Commentary further states that the ex-post annualized charge operates by way of self-assessment, indicating that residents of one jurisdiction only need to submit a tax return in the other jurisdiction if they have a tax liability under the STTR at the end of a fiscal year.

The competent authorities of the jurisdictions may by mutual agreement settle the mode of application of the provisions contained in the STTR. The Commentary indicates that they also may consider complementing the ex-post annualized charge approach with a certification system that would allow a nonresident to obtain a certificate confirming that is not liable to tax under the STTR and thus relieve the nonresident from the obligation of submitting a tax return.

Other aspects of the STTR

The STTR contains specific provisions regarding Permanent Establishments (PEs). In situations where the head office conducts business in the source jurisdiction and the covered income arises through a PE situated there, the STTR would not apply if the covered income is effectively connected or attributable to that PE. Instead, the provisions of Article 7 (business profits) of the OECD Model Tax Convention would apply.

The STTR also addresses the situation in which covered income is attributable to a PE in a third country. If the tax rate applicable to an item of covered income arising in one of the jurisdictions, derived by an enterprise of the other jurisdiction, is lower than 9%, and both the residence jurisdiction of the enterprise and the third jurisdiction treat the income as attributable to the PE, the applicable tax rate for STTR purposes would be the rate in the third jurisdiction if it is higher than the tax rate in the residence jurisdiction.

The STTR grants a limited taxing right to the source jurisdiction and, in some cases, supplements an existing limited taxing right already held by the source jurisdiction. Thus, the STTR operates as an exception to the other tax-treaty rules that typically would otherwise restrict the source jurisdiction's ability to levy taxes. Consequently, this creates an interaction between the STTR and the provisions related to eliminating double taxation in tax treaties. The STTR document includes model provisions that preserve the position under the elimination-of-double-taxation articles that would have applied before application of the STTR. The residence jurisdiction is not required to exempt the covered income because of tax payable under the STTR nor to provide a tax credit for tax payable under the STTR.

Implications

The STTR is a core element of Pillar Two and, where applicable, the STTR would apply before the GloBE Rules.

Inclusive Framework jurisdictions that have nominal corporate tax rates below 9% have committed to implementing the STTR through tax-treaty amendments when asked to do so by a developing country that is an Inclusive Framework jurisdiction. However, the actual timeline for treaty changes to come into force remains uncertain.

Companies should evaluate the potential implications of the STTR for their businesses and monitor STTR developments in relevant jurisdictions.

German Ministry of Finance proposes interest-rate limitation rule

On 14 July 2023, the German Ministry of Finance (MoF) published the draft of the Growth Opportunities Act, which would constitute the biggest corporate tax reform in Germany since 2008. In part, the draft bill proposes an interest-rate limitation rule that is included in the coalition agreement dated 24 November 2021 between the three political parties forming the current German government.

This rule would deny deductions of interest expenses paid to related parties to the extent the interest rate at issue exceeds a maximum interest rate defined by law. The maximum interest rate is the base interest rate according to the German Civil Code (currently 3.12%, but updated every six months) plus 200 basis points. The proposed rule offers two alternative "escape clauses" that would allow the application of a higher (arm's-length) interest rate, however.

The proposed rule represents a further attempt by the German legislature to limit the interest-expense deduction of a borrower in an intercompany financing transaction with an affiliated lender with no or low substance. Previous efforts to limit these expense deductions either failed in the legislative process or were contradicted by jurisprudence of the German Federal Fiscal Court.

Detailed discussion

As stipulated in the explanatory notes to the draft bill, the German legislature acknowledges that under case law of the German Federal Fiscal Court, the arm's-length interest rate for cross-border loans is generally determined based solely on the financial strength of the borrowing entity. According to the German MoF, this results in tax structuring opportunities to shift profits to low-tax foreign countries. Hence, the introduction of an interest-rate limitation rule is proposed to prevent arrangements involving lending entities without substance. This would limit the deduction of interest expenses in such cases to a "reasonable" amount in the view of the German legislature.

According to the proposed rule, interest expenses are not deductible to the extent that they are based on an interest rate that exceeds the maximum interest rate, defined as the base interest rate according to the German Civil Code plus 200 basis points. The German Central Bank publishes the base interest rates on a bi-annually basis (on 1 January and 1 July). As of 1 July 2023, the current base interest rate amounts to 3.12%, resulting in a maximum interest rate of 5.12%.

The proposed rule only applies in business transactions between related parties as defined in the German Foreign Tax Act (FTA) and covers cross-border and domestic intercompany financing transactions.

Two alternative "escape clauses" are available that would allow the application of a higher (arm's-length) interest rate. First, if the taxpayer can demonstrate that both the lender and, in the case of a group of companies, the ultimate parent company could only obtain the funds (with otherwise equal conditions) at an interest rate higher than the maximum interest rate defined by law, the maximum interest rate shall be deemed to be the interest rate these parties could have obtained in the most favorable case.

Second, the interest-rate limitation rule would not apply if the lender were engaged in a "substantial economic activity" in the state in which it has its registered office or management (substance exception). Regarding the interpretation of the term "substantial economic activity" the draft law explicitly refers to the German controlled foreign company (CFC) rules in the FTA. These CFC rules were amended in 2021 through the implementation of European Union (EU) Anti-Tax Avoidance Directive (ATAD) Implementation Law.

To fulfill the "substantial economic activity" requirement, the lender must have appropriate operating substance and human resources necessary for the activity. The requirement is to be met in a qualitative, not quantitative way. Moreover, the lender's personnel must be qualified and perform the activities independently and autonomously; outsourcing of activities is viewed negatively with regard to qualifying for the exception.

It should be noted that the substance exception does not apply if the lender is resident in a jurisdiction that is not obliged to provide administrative assistance to Germany in accordance with the OECD standard for transparency and does not ensure effective exchange of information upon request.

Based on the current draft bill, the proposed interest-rate limitation rule will apply from 1 January 2024 onward and does not grandfather existing financing arrangements. The draft bill is scheduled to be discussed within the entire government in mid-August. On this basis, a legislative process could be completed by end of 2023.

The effect of the rule should be limited to denying the "excessive" portion of interest, and not lead to recasting the debt into equity, nor to a withholding tax obligation.

Implications

Potentially affected taxpayers should note the proposed introduction of an interest-rate limitation rule and closely monitor further developments during the legislative process.

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Important dates

15 August 2023	Due date for monthly instalments
31 August 2023	6th month revision of tax estimates for companies with February year-end
31 August 2023	9th month revision of tax estimates for companies with November year-end
31 August 2023	Statutory deadline for filing of 2023 tax returns for companies with January year-end. A blanket extension of time has been provided until 30 September 2023.
31 August 2023	Extended 2022 tax return filing deadline for companies with December year-end.
15 September 2023	Due date for monthly instalments
30 September 2023	6th month revision of tax estimates for companies with March year-end
30 September 2023	9th month revision of tax estimates for companies with December year-end
30 September 2023	Statutory deadline for filing of 2023 tax returns for companies with February year-end. A blanket extension of time has been provided until 31 October 2023.
30 September 2023	Extended 2023 tax return filing deadline for companies with January year-end.

APAC no. 07009974
ED None.

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