



Think Ahead



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Taxation of individuals – advanced aspects

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/ **Taxation of individuals – advanced aspects**

This article was last updated in March 2014. It is now updated to prevailing tax laws as at 31 March 2016.

It is presumed that the reader already has a comprehensive understanding of the fundamentals of personal taxation in Malaysia. The reader is also expected to be conversant with the contents of the following public rulings:

- PR 8 of 2013 – Gratuities
- PR 3 of 2013 – Benefits in kind
- PR 2 of 2013 – Perquisites from employment
- PR 11 of 2012 – Employee share scheme benefit
- PR 1 of 2012 – Compensation for loss of employment
- PR 8 of 2011 – Foreigners working in Malaysia
- PR 6 of 2011 – Residence of individuals
- PR 1 of 2011 – Taxation of Malaysian employees seconded overseas

- PR 3 of 2005 – Living accommodation benefit provided for employee by employer
- PR 2 of 2005 – Computation of tax payable by a resident individual
- PR 1 of 2005 – Computation of total income for an individual

This article endeavours to bring together all the advanced aspects of personal taxation to afford the candidate an overall picture of taxation of individuals in Malaysia.

The aspects or factors which should be borne in mind when planning for an individual structuring an optimal compensation package or considering a cross-border move are as follows:

- A. Tax rates
- B. Residence planning
- C. Contracts of service and contracts for service
- D. Cash and non-cash remuneration
- E. Lump sum payments
- F. Employee share option scheme
- G. Anti-avoidance provisions
- H. Exemption under DTA
- I. Exemptions under the Income Tax Act

A. Tax rates: effective, average and marginal rates

Effective rate means the same as 'average rate'. This concept is relevant in Malaysia because resident individuals are allowed personal reliefs and the remainder is subject to tax at scale or progressive rates across several tax bands. The marginal rate is the highest rate reached by the resident individual given his income level. For a non-resident individual, who is not allowed any personal reliefs, and who is taxed at a fixed rate of 28%, his effective tax rate is 28% – ie the same as his marginal rate.

Illustration 1

By way of illustration, assume that Miss Emm derives an annual gross income of RM180,000 from employment and is eligible for personal reliefs amounting to RM20,000. Her income tax liability for the relevant year is computed as follows:

RM

Gross/total income

180,000

RM

Less Personal reliefs	(<u>20,000</u>)
Chargeable income	<u>160,000</u>
Income tax on first RM100,000	11,900
Income tax on the remaining RM60,000 at 24%	<u>14,400</u>
Tax charged	<u>26,300</u>

Effective/average tax rate $\frac{\text{Tax charged}}{\text{Gross income}} = \frac{26,300}{180,000} = 14.61\%$
 Marginal rate (the last applicable rate) 24%

Based on the above calculations, it may be discerned that Miss Emm's income is subject to tax at an average rate of 14.61%, but any additional income beyond her current level of income will be taxed at 24% or more.

B. Residence planning

The tax residence status of an individual has a direct impact on the following:

- The applicable tax rate or the effective tax rate at which his income derived from Malaysia will be levied
- His eligibility for personal reliefs and tax rebates
- His eligibility for certain tax exemptions
- His eligibility for tax treaty benefits and double tax relief

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As such, individuals who take up employment or business activities in Malaysia, and individuals who return to Malaysia after a

prolonged absence are well advised to carefully plan their pattern of physical presence in Malaysia to achieve tax residence status or tax non-residence status.

Illustration 2

Mr Asing expects to arrive in Malaysia for the first time in the last quarter of the year for a seven-month project as a representative of his employer which is a non-resident company. As it stands, three months in Year 1 and four months in Year 2 will not allow Mr Asing to achieve tax residence in either Year 1 or Year 2.

Residence planning, by rescheduling his stay in Malaysia into seven months entirely in Year 2 will facilitate tax residence status for Year 2.

Alternatively, a half month in Year 1 and six and a half months in Year 2, with no absences from Malaysia other than permitted 'temporary absences' will enable Mr Asing to qualify for tax residence for both Year 1 and Year 2.

Alternatively, if the job demands that the three months in Year 1 be strictly adhered to, prolonging the total length of uninterrupted presence in Malaysia in Year 2 to at least 182 days will similarly enable Mr Asing to qualify for tax residence in both Year 1 and Year 2. Remember that the extra days of physical presence need not be work-related.

From another perspective, it may be that Mr Asing may wish to avail himself of the tax exemption for short-term employment in paragraph 21 of Schedule 6. In this case, residence planning will have to focus on Mr Asing preserving his non-residence status, and on having Mr Asing's employment in Malaysia last no more than 60 days in Year 1, or in Year 2 or in the two-year period. Remember here that the 60-day threshold refers to the period of employment, not the physical presence of Mr Asing.

As demonstrated in the illustration above, residence planning requires sound and detailed knowledge of all the rules of tax residence of individuals, especially that of s7(1)(b) and the tax exemption afforded in paragraph 21 of Schedule 6 relating to short-term residence.

C. Contract *of* service and contract *for* service

If it is established that an employment exists and is exercised in Malaysia, or the employment income is otherwise deemed derived from Malaysia, the employment income will be taxable in Malaysia notwithstanding that payment is made outside Malaysia.

Employment is said to exist where there is a master-servant relationship that denotes an employer-employee situation. This is a contract *of* service.

A contract *for* service, on the other hand, calls to mind a principal-agent relationship, or principal and independent contractor relationship – ie an inter-dependent relationship where the agent/contractor executes contractual tasks in return for a fee. Income accruing to a person in respect of a contract *for* service is not employment income and will therefore fall outside the ambit of

employment income under s4(b). Such income would be treated as income from exercising a profession or carrying on a business, both **chargeable to tax under s4(a)**.

Factors for determination

Whether a contract is one of service or for service is a question of fact. The circumstances of the case should be fully ascertained to facilitate its determination.

- **Extent of control**

The distinction between master and servant and an independent contractor is generally that in the case of a servant, the employer has the **power to direct what the servant is to do and** also to direct *how* the work is to be done, while an agent or independent contractor has relatively **more independence in these aspects**

- **Degree of skill**

The 'how' question or the control factor depends on the degree of skill involved. Clearly, the amount of direction given is dependent upon the skills of the parties concerned. However, it must be noted that the fact that an individual is highly skilled does not necessarily preclude him from being a servant to the employer.

Illustration 3

Facts

Dr Ekspert is a highly-trained and experienced medical specialist. He is employed by ABC Medical Centre as the chief surgeon. He works full-time for the medical centre and is paid a monthly salary with bonus.

Tax treatment

It is highly unlikely that the diagnoses or professional decisions of Dr Ekspert would be subject to any supervision. Nevertheless, he is an employee of ABC Medical Centre because the medical centre has a lawful authority to command him so far as there is scope for it.

- **The nature of remuneration**

The name tag for the remuneration may throw light, but is often not conclusive as on the nature of the payment. Merely describing remuneration as 'fees' rather than as wages does not decisively lead to the conclusion that there is an employment or otherwise.

An employee normally receives a fixed monthly remuneration while a contractor/agent receives payment based on his output or deliverable. Having said that, an employee may also be paid commission, bonus incentive payment, etc, based on performance.

- **Full-time/part-time**

An employee normally works full-time for his employer. However, be mindful that the full-time or part time nature of an arrangement does not by itself decide whether it constitutes an employment.

- **Freedom to contract with other parties**

A contract that specifically disallows a party from similarly contracting with others may prima facie lead to a presumption that the contract was one of employment. The restrictive covenant should, however, be examined to ascertain the extent of its exclusivity.

If the effect is such that there is residual scope for the individual to contract rather than render him completely excluded from a capacity to contract, it is possible that it is not an employment.

- **Exercising profession or employment**

An individual who exercises a profession in his own right and not under an employment is treated as carrying on a

business.

Tax treatment

- *Basis of assessment*

With effect from the year of assessment 2016, the basis period for employment income has been overhauled: **employment income is now taxable in the year it is received. No longer is it related to the period for which it is receivable.** This change is introduced to avoid re-opening prior year assessments to tax gratuities and payments made in arrears.

Business income is taxable on accrual basis – ie taxable in the basis period it first becomes receivable, regardless of whether it is received. Additionally, with effect from the year of assessment 2016, any amount received in advance in respect of a business source of income is treated as income in the year the amount is received, regardless of whether the goods have been sold, services rendered or amenities enjoyed.

The basis year – ie the calendar year – continues to be the basis period applicable to an individual in respect of all his sources of income, including business source [section 21]. Therefore, for an individual carrying on a business, the accounts should be made up to 31 December each year.

- *Losses*

Only losses arising out of a business source (ie from a trade, profession or vocation) can be deducted against other sources of income in the basis period the loss arises. If the current year loss is not absorbed in that year of assessment, any unabsorbed amount is carried forward to be set off against statutory income from all business income in the future.

- *Capital allowances*

An individual exercising an employment is not entitled to claim capital allowances on capital expenditure incurred on plant and machinery for use in his employment. Capital allowances are only granted in respect of a business source of income.

- *Deductions*

There is generally a wider scope for deductions for a business than for employment. In fact, some expenses – eg bad debts, interest, rental, etc – are only deductible in respect of a business.

D. Cash and non-cash remuneration

Remuneration for an employment may come in the form of cash and/or benefits in kind. Cash remuneration is straightforward in that the amount paid is the amount taxable as gross employment income. Benefits-in-kind, however, involve the valuation of such benefits. Therefore, the significance of non-cash remuneration is in its valuation for tax purposes. Such a value is added on to the cash remuneration in totalling up the gross income from employment.

These values are mainly provided in the Public Ruling 3 of 2013. S13(1)(c) spells out the basis of valuation by restricting the defined value of the accommodation provided to 30% of the remuneration under s13(1)(a).

Effectively, the employee derives the benefit of the company car, the free living accommodation, the domestic servant, the driver and leave passage, by bearing the tax chargeable on such prescribed values rather than defray the full cost of such benefits.

Illustration 4

Mr Mustahak is provided with the free use of a company car (worth RM120,000 when new) and free living accommodation

(defined value: RM48,000 per annum). His child's school fees of RM14,000 is borne by his employer. He draws a monthly salary of RM8,000.

If Mr Mustahak were to be paid entirely in cash, his monthly salary would be RM14,000. The monthly rental of a car similar to the one he is provided with is RM500.

To determine the relative advantage of each package, a computation of Mr Mustahak's disposable income for each of the packages would be instructive, as follows:

	RM	RM	RM	RM
Annual salary		96,000		168,000
Perquisite; Child's school fee		<u>14,000</u>		<u>nil</u>
S13(1)(a) remuneration		110,000		168,000
Car benefit		5,000		nil
Living accommodation: Lower of defined value and 30% of s13(1)(a)		<u>33,000</u>		<u>nil</u>
Employment income		148,000		168,000
Personal reliefs (9,000+6,000+1,000)		<u>(16,000)</u>		<u>(16,000)</u>
Chargeable income		<u>132,000</u>		<u>152,000</u>
Less Tax charged				

	RM	RM	RM	RM
On first RM100,000	11,900		11,900	
On remaining RM32,000 at 24%	<u>7,680</u>			
On remaining RM52,000 at 24%			<u>12,480</u>	
Total tax charged	<u>19,580</u>		<u>24,380</u>	

		Cash and BIK	Cash
Income		96,000	168,000
<i>Less</i>			
11% EPF		(10,560)	(18,480)
Income tax		(<u>19,580</u>)	(<u>24,380</u>)
Net income		65,860	125,140
<i>Less</i>			

	Cash and BIK	Cash
Child's school fee	Nil	(14,000)
Car rental	Nil	(6,000)
House rental	<u>Nil</u>	<u>(48,000)</u>
Disposable income	<u>65,860</u>	<u>57,140</u>

(Note: Personal reliefs are for self, EPF and child)

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Analysis

Although the cash package brings a substantially higher gross income, it yields a lower disposable income because:

- the cash-and-benefit package produces a lower chargeable income as lower taxable values are attributed to the car and accommodation benefits
- under the cash-and-benefit package, Mr Mustahak merely bears the tax on the values attributed to the benefits, while under the cash package he has to bear the actual expenditure of such benefits.

However, it should be noted that the cash package provides a larger base figure for EPF contributions.

Conclusion

The cash-and-benefit package obviously presents a more advantageous outcome to Mr Mustahak because he has a higher disposable income after accounting for essential expenditure such as his child's education, housing and the use of a car.

However, it should be borne in mind that the cash package, being a larger figure, is more advantageous for the purposes of EPF contributions, bonuses, salary increments or the starting salary for a new job.

Incidentally, it should be noted that in computing the value of living accommodation, the reference to gross income under s13(1)(a) shall not include the amount of gross income in respect of any right to acquire shares in a company.

E. Lump sum payments

At or about the time of cessation of employment, lump sums are usually payable. These may be payable as compensation for the loss of employment or for a restrictive covenant, or as gratuity on the completion of a contract of service or on retirement.

These lump sums are accorded different tax treatment. There are also some tax exemptions if the requisite conditions are satisfied.

Compensation for the loss of employment

This specifically constitutes gross income from employment under **s13(1)(e)**. It includes **any payment for restrictive covenant after the cessation of employment, as well as any payment made under a voluntary separation scheme (with no express re-employment provision)**.

If the loss of employment is **due to ill-health**, the entire amount of the compensation paid is **tax exempt** under paragraph 15(1)(a) of Schedule 6 of the Income Tax Act.

If ill-health is not the reason for the loss of compensation, there is an exemption [under paragraph 15(1)(b) of Schedule 6] of **RM10,000 for every completed year of service with the same employer or with companies in the same group**.

The remainder, if any, will be subject to tax as income in the year the compensation payment first becomes receivable.

Do note that any compensation receivable by a **non-service whole-time director from a controlled company does not rank for any tax exemption at all, be it for ill-health or otherwise. This is an anti-avoidance provision.**

Gratuity

A gratuity is gross income from employment pursuant to **s13(1)(a)**. The significance of this classification is that it **will increase the base figure on which the 30% is calculated in arriving at the value of living accommodation**.

There is a tax exemption [under paragraph 25 of Schedule 6] for a gratuity if the retirement is:

- (a) **due to ill-health, or**
- (b) **on or after reaching 55 years of age or the compulsory retirement age under any written law, after having served at least 10 years with the same employer or with companies in the same group, or**
- (c) **on or after reaching 50 years of age, but before 55 years, pursuant to a contract of employment or collective agreement, after having served at least 10 years with the same employer or with companies in the same group.**

The exemption applies to the entire amount of gratuity received.

With effect from the year of assessment 2016, if a gratuity **does not qualify for tax exemption as stated above, there is a residual exemption of RM1,000 for each completed year of service. Any balance is then subject to tax in the year it is received.**

Comparative analysis

	Compensation for loss of employment	Gratuity
Tax provision	s13(1)(e)	s13(1)(a)
Exemption for ill- health	Yes	Yes
Exemption for other requisites	RM10,000 for every completed year of service	Total exemption if all requisites are satisfied. If one does not qualify for exemption, there is an exemption of RM1,000 for every completed year of service
If taxable, basis period in which taxable	In the basis year it is received	In the basis period it is received
Anti-avoidance provision	No exemption for compensation paid to non- service director of controlled company	None
Tax treatment, generally stated	Partial exemption and the remainder taxable in the year it is received	Full exemption if the conditions are fulfilled, failing which there is partial exemption. Any remaining taxable amount is taxable in the year it is received

Tax planning

In view of the differing tax treatment for the two events that sometimes may be confused with each other, pre-planning may reduce the tax exposure.

If the contemplated cessation of employment occurs not too far ahead of the time of statutory or contractual retirement age, and the requisite conditions of a minimum of 10 years of continuous service with the same employer are satisfied, pre-planning the cessation as a retirement will lead to total tax exemption.

If the above requisites are not satisfied – ie the individual is not anywhere near retirement age, but has some completed years of service with the same employer – the individual should try to attain the largest number of completed years as there is an exemption of RM1,000 for every completed year of service.

Additionally, it may help mitigate tax liability to structure the cessation as a loss of employment or a voluntary separation, as that will afford an exemption of RM10,000 for every completed year of service.

The planning will also depend on the marginal rate of tax in the relevant years. For instance, a compensation for loss of employment will render the remainder sum taxable as a lump sum in the year it is received. This may vastly increase the marginal rate of tax. On the other hand, planning it as a retirement, even though not eligible for exemption, will render the sum being spread over up to five basis years, which may render the taxable income to fall under a lower tax band – therefore a lower marginal rate. However, this planning opportunity is no longer available with effect from the year of assessment 2016 as all employment income is recognised in the year of receipt.

F. Employee share option scheme (ESOS)

A share option is a benefit in connection with one's employment. It is pertinent to determine when and how much income is taxable.

When taxable?

Income from shares benefit arises (therefore taxable) when the option is *exercised*. (Note: This contrasts with the old treatment prior to the year of assessment 2006 when income was deemed to arise when the option was *granted*.)

'Exercising an option' means exercising the right and actually acquiring the shares at the offer price.

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How much is taxable?

The taxable benefit is the difference between the market value of the shares when the option is exercised and the amount actually paid by the employee to acquire the shares. See Illustration 5 below.

If the option period extends over a specified period, then the market value of the shares on the first day of the option period is compared to the market value of the shares on the day the option is exercised. See Illustration 6 below.

Illustration 5

Mr Vee was given the option to acquire 2,000 shares of his employer company on 1 February 2014 at RM1.00. Mr Vee duly exercised the option on 1 February 2014 when the market value of the shares was RM1.45.

The value of the benefit is computed as follows:

RM

Market value of shares on the date the option is exercised	1.45
------------------------------------------------------------	------

Less:

Amount paid by Mr Vee	<u>1.00</u>
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Share benefit per share	<u>0.45</u>
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Share benefit for 2,000 shares @ 0.45 per share	<u>900</u>
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The RM900 is taxable in the year of assessment 2014 because the share option was exercised in the year of assessment 2014.

Illustration 6

Mr Yue was given the option to acquire 2,000 shares of his employer company on 1 February 2014 at RM1.00. He is given a period of 12 months to exercise the option.

On the first day of that 12-month option period (ie 1 February 2014), the market value of the shares of the employer company was RM1.45, but when he exercised the option and purchased the 2,000 shares on 10 January 2015, the market value had risen to RM1.80.

His share benefit is calculated as follows:

RM

RM

Market value of shares on

the first day of the option
period – ie 1 February 2014

1.45

the day the option is
exercised – ie 10 January
2015

1.80

The lower of the 2 values

1.45

Less

Amount paid by Mr Yue

1.00

Value of benefit per share

0.45

Share benefit for 2,000 shares @ 0.45 per share

900

The RM900 is taxable in the year of assessment 2015 as the share option is exercised in the year of assessment 2015.

Illustration 7

On 1 February 2014, Mr Tee was given the same 12-month option period to acquire 2,000 shares of his employer company at RM1.00, and he exercised the option on 15 January 2015.

On the first day of that 12-month option period (ie 1 February 2014), the market value of the shares of the employer company was RM1.45, but when he exercised the option and purchased the 2,000 shares on 15 January 2015, the market value had dropped to RM1.25.

RM

RM

Market value of shares on

the first day of the option
period – ie 1 February 2014

1.45

the day the option is
exercised on 15 January
2015

1.25

The lower of the 2 values

1.25

Less

Amount paid by Mr Tee

1.00

Value of benefit per share

0.25

Share benefit for 2,000 shares @ 0.25 per share

500

The RM500 is taxable in the year of assessment 2015 because the share option is exercised in the year of assessment 2015.

G. Anti-avoidance in personal tax

The anti-avoidance provisions relating to individuals are:

1. Income splitting – settlements under s65

2. Restrictions applicable to a non-service director of a controlled company:

- Compensation for loss of employment – No exemption of RM10,000 for each completed year of service (see paragraph E above)
- Value of living accommodation benefit – No restriction of taxable benefit to the lower of defined value and 30% of s13(1)(a) income.

Note: Refer to [this article](#) for more detail explanations regarding settlements and computation of value of living accommodation.

3. Income deemed obtainable on demand under section 29:

Where interest income, employment income, rent, royalty, pension, annuity, other periodical payment and other income arise out of transactions between individuals who are relatives of each other, and it first becomes receivable in a basis year, it is deemed to be obtainable on demand in the immediately following basis year. When an amount is obtainable on demand, it is deemed to be received. As income is subject to tax when it is received or deemed received, the recipient individual is subject to tax in respect of such amounts in the year following the year it first becomes receivable.

Illustration 8

Mr A employed his son, Jason, in his business, at a monthly salary of RM10,000. However, the RM120,000 for 2015 was not paid to Jason.

Mr A and Jason are father and son. Hence they are relatives as defined in section 140(8). Pursuant to section 29(4), the RM120,000 salary is deemed obtainable on demand in 2016, the year immediately following 2015, the year it first becomes receivable. Jason will therefore have to report the employment income of RM120,000 for YA2016.

H. Exemption/relief under DTA

There is an exemption available under a double tax agreement (DTA) based on fulfilment of all three of the following conditions:

1. Period of stay of the employee is not more than 183 days
2. Services are performed for a non-resident employer
3. Employee's remuneration is not borne by a permanent establishment (PE) of the non-resident employer.

Details are as follows:

Condition

Comment

	Condition	Comment
1	The employee is present in the other state for period/periods not exceeding 183 days during the relevant calendar year, or which form part of a continuous period of more than 183 days in any continuous 12-month period (moving 12-month period)	In counting the days, physical presence is required. Whether it is 183 days in a calendar year or in a moving 12-month depends on the provision of the DTA concerned
2	The services are performed or remuneration is paid for or on behalf of the employer who is not a resident of the other state	In determining whether the payer of remuneration is the bona fide employer or merely an intermediary, substance will prevail over form
3	The remuneration is <i>not</i> borne by a PE or fixed base which the employer maintains in the other state	If the PE pays the remuneration directly to the employee but it charges the head office for it, the PE does not bear the remuneration

Illustration 9

Facts

Mr ABC was in Malaysia during the period 20 September 2013 to 10 February 2014 (144 days), carrying out a market survey and feasibility study for his employer Foreign Ltd, a company resident in Foreign Country, with whom Malaysia has signed a DTA that has come into force.

Mr ABC's salary during the period was paid by the Kuala Lumpur branch office of Foreign Ltd which, in turn, would recover such payments from the Foreign head office as it was not attributable to the Kuala Lumpur branch business operations.

Mr ABC left Malaysia on 10 February 2014 and thereafter did not return to Malaysia.

Tax treatment

Under the Foreign Country-Malaysia DTA, Mr ABC would be exempt from tax in Malaysia in respect of his income derived from Malaysia during the period because:

- he was in Malaysia for less than 183 days in the continuous 12-month period
- while in Malaysia, he performed services for his employer who is not resident in Malaysia, and

- although he was paid by the PE of Foreign Ltd, it was a payment on behalf of the head office in Foreign Country. Therefore, his remuneration was not borne by the PE in Malaysia.

I. Exemptions under the Income Tax Act

Below are other exemptions provided to individuals:

- Pension granted under written law or approved scheme
- Scholarship, grant or allowance, whether or not in connection with employment
- Maximum of RM2,000 a year for perquisite consisting of long service, past achievement, service excellence, innovation or productivity award
- Royalty of up to RM10,000 a year from publication of artistic work (other than paintings) and, recording discs or tapes
- Royalty of up to RM20,000 a year from publication of literary work or original paintings
- Royalty of up to RM20,000 from musical composition, and
- Interest income from Malaysian registered financial institution.

Written by a member of the P6 (MYS) examining team



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