MALAYSIAN BUDGET 2007 SUMMARY

4 September 2006

Preface

On Friday, 1 September 2006, Malaysian Prime Minister and Finance Minister, Abdullah Ahmad Badawi, delivered his 2007 Budget Speech in Parliament, introducing the Supply Bill (2007).

In his Budget Speech, themed "Implementing the National Mission Towards Achieving the National Vision", the Prime Minister moved the second reading of the Supply Bill intituled "An Act to apply a sum from the Consolidated Fund for the service of the year 2007 and to appropriate that sum for the service of that year".

As in the previous year, slowing world growth and rising international oil prices remained the backdrop to an upbeat speech containing expectations of broad-based growth in 2006/2007. This year, however, the Government has committed itself to an expansionary fiscal strategy and measures to stimulate the private sector.

The corporate income tax rate will be progressively cut for the first time in nine years—to 27 percent in 2007, and 26 percent in 2008—without any significant compensatory taxes elsewhere. Developmental expenditure will be massively increased, especially on human capital. Worrying inflationary trends will be addressed through oil subsidies and tax breaks, as well as intensifying enforcement of essential goods price controls.

In addressing the country's delivery systems, the Prime Minister also admonished Federal, State and local authorities for frustrating rather than facilitating licenses and other approvals, and being derelict in condoning environmental degradation that caused flashfloods and landslides, and the loss of life and property.

In closing, the Prime Minister exhorted Malaysians to "always have an open mind and be willing to learn and relearn". "Life … is too short for unnecessary bickering", he said.

The following are some of the highlights and major proposals in the 2007 Budget Speech:

Budget Strategy

The 2007 Budget is presented as an action plan for the National Mission set out in the Ninth Malaysia Plan. The National Mission contains the following five key thrusts:

> "First: To move the economy up the value chain;
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> Second: To raise the capacity for knowledge and innovation and nurture 'first class mentality';
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> Third: To address persistent socio-economic inequalities constructively and productively;
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> Fourth: To improve the standard and sustainability of quality of life; and
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> Fifth: To strengthen the institutional and implementation capacity."

To implement the above strategies the Government will appropriate RM159.4 billion (US$43.3 billion[1]) to the 2007 Budget, comprising Operating Expenditure of RM112.9 billion (11.6 percent higher than 2006) and Development Expenditure of RM46.5 billion (31 percent higher than 2006).

Operating Expenditure will be distributed as Fixed Charges and Grants, 53.1 percent (2006: 53.3%); Emoluments, 22.9 percent (2006: 23.3%); Services and Supplies, 20.5 percent (2006: 20.3%); Purchases of Assets (e.g. office equipment and facilities) 1.9 percent (2006: 1.6%); and other expenditures, 1.7 percent (2006: 0.5%).

Under Development Expenditure, the largest distributions are 44.7 percent to the economic sector (i.e. infrastructure, agriculture and industry) (2006: 40.1%); 30.5 percent to the social sector (which includes education and training, health and housing) (2006: 27.9%); 14.6 percent to the security sector (2006: 15.8%); and 5.8 percent for general administration (2006: 10.1%).

[1] US$1.00=RM3.679

With Federal Government income continuing to increase mainly due to oil and gas revenues, the fiscal deficit is expected to reduce from an estimated 3.5 percent of GDP in 2006, to 3.4 percent in 2007.

Economic Performance[2]

- GDP is projected to grow at 5.8 percent in 2006 (2005: 5.2%) and 6 percent in 2007. These expectations are based, among others, on robust domestic demand and increased private investment

- The services sector—the largest sector of the economy, including transport, storage and communications, and representing 58.2 percent of GDP—is expected to grow 5.7 percent in 2006 (2005: 6.5%) driven mostly by domestic consumption and expanding trade

- The manufacturing sector, representing 32 percent of GDP, is expected to grow strongly by 7.3 percent in 2006 (2005: 5.1%) driven by the global up-trend in electronics demand

- The country's balance of payments improved further during the year with the current account expected to record a large surplus of 16.7 percent of gross national product in 2006, on the back of an 11 percent increase in export earnings. As in the past, Malaysia's largest trading partners were the United States, Singapore and Japan

- The 2006 fiscal deficit is expected to duly reduce to 3.5 percent of GDP (2005: 3.8 percent)

- No changes to monetary policy were mooted despite inflationary pressures and widening interest-rate differentials. The CPI (re-based to 2005) increased 3.9 percent in the first seven months of 2006, but the Prime Minister argued that this was "much lower compared with other countries in the region". In a separate report it was stated that Bank Negara's (Central Bank's) overnight policy rate, raised twice during 2006, "remains below the neutral level, reflecting a supportive monetary stance"

- A key determinant of economic strength, Malaysia's international reserves remained strong at RM291.051 billion (US$79.111 billion) as at 15 August 2006 (end-December 2005: US$72.102 billion) due to sustained repatriation of export earnings and steady inflows of foreign capital. International reserves were sufficient to finance 8.1 months of retained imports

[2] To compile this summary, reference is also made to the Ministry of Finance's just-released Economic Report 2006/2007, as well as the periodic releases of the Economic Planning Unit, Department of Statistics and others

- Unemployment is expected to remain below 4 percent in 2006 continuing the country's effective full employment position since 1992. Per capita income is expected to increase to RM19,740 (2005: RM18,040) and purchasing power parity, to US$11,870 (2005: US$10,610)

- At the end of June 2006, there were 1.84 million registered foreign workers mostly emanating from Indonesia and comprising approximately 16.5 percent of total employment in the country (end-May 2005: 1.62 million and 15%, respectively). One third of foreign workers are employed in the manufacturing sector

- There were 33,448 foreign professionals, specialists and skilled workers in the country at the end of June 2006 (end-December 2005: 33,062) mostly emanating from India, Japan and China. Forty-five point one (45.1) percent of these highly skilled workers were employed in the services sector and 39.5 percent in manufacturing

Budget Proposals

Tax Reform

- The basic income tax rate currently applicable to companies and trusts is 28 percent (although, small/medium-scale companies with paid-up capitals not exceeding RM2.5 million are taxed at only 20 percent on the first RM500,000 of chargeable income). It is proposed that the basic income tax rate for companies and trusts (28 percent) be reduced to 27 percent with effect from year of assessment 2007, and 26 percent, with effect from year of assessment 2008

- From 1 January 2007, specific amendments to the Income Tax Act 1967 will empower taxpayers to request a mutually binding advance ruling from Director-General of Inland Revenue on the tax treatment for a year of assessment of any "arrangement" to be made by the taxpayer. However, the relevant Finance Bill provides that the Director-General will not be bound by his own material assumption in an advance ruling if that assumption should prove incorrect. Rules and fees will be prescribed for applications/rulings. (It should be noted that a somewhat informal system of private rulings has always existed; however, the practical effects of these private rulings were invariably non-binding on the Director-General.)

- The new advance ruling system is not to be confused with the existing public ruling system wherein the Director-General's various interpretations of the tax laws are published on a non-binding basis. The last-mentioned public ruling system will now also be entrenched in the Income Tax Act 1967

- To enhance tax administration in the country, the Inland Revenue Board (IRB) has also been directed to issue clearer and more comprehensive guidelines for tax audits and investigations with effect from 1 January 2007, especially to clarify the respective duties and obligations of officers and taxpayers. The IRB has published a guide on its tax audit procedure; however, the tax investigation procedure is not similarly supported, and it is fair to say that taxpayers have not been comfortable hitherto with IRB's audit or investigation methodologies

- A Customs Appeal Tribunal will be established from 1 March 2007, to hear appeals against decisions of the Director-General of Customs under the Customs Act 1967, Sales Tax Act 1972, Service Tax Act 1975 and Excise Act 1976. The Tribunal, which will comprise members of the judicial and legal service, and others with relevant experience, will replace the current unsatisfactory system of appealing to the Minister of Finance

- Customs will also be bound by a formal advance ruling procedure from 1 January 2007. Presently, Customs' guidelines and determinations concerning the above-mentioned laws (e.g. on the classification or valuation of dutiable goods or taxable services) are notably *ad hoc* in nature leading to inconsistencies in the application of the law. The advance rulings will be pursuant to written application and will be mutually binding for (presumably) an agreed period. Fees will be prescribed for applications/rulings; however, no draft legislation is available at the time of writing

- Sales tax and service tax accounted for by licensees in connection with uncollected receivables is refundable by Customs subject to stringent criteria, including the expiry of twelve (12) months from the date the tax is paid to Customs. With effect from 1 January 2007, the last-mentioned period is shortened to six (6) months, with certain other implementation measures modified accordingly

Manufacturing Sector

- Manufacturing companies (as well as agriculture and tourism companies) that invest in the promoted areas of Kelantan, Terengganu, Pahang, the District of Mersing (Johor), Sabah and Sarawak are eligible for Pioneer Status, Investment Tax Allowance or Infrastructure Allowance for which applications can be made to the Malaysian Industrial Development Authority until the end of 2010. The state of Perlis will now also be a promoted area encompassing (presumably) the same sectors and timeframes

- In excess of RM800 million has been allocated to enhance skills development programmes, by way of building and upgrading polytechnics, colleges and industrial training centers, as well as supporting MARA and UniKL programmes, and "production-based education" at the German-Malaysia and British-Malaysia Institutes

Property/Construction Sector

- The cut in the corporate income tax rate and the huge increase in development expenditure should give a long-awaited fillip to the property and construction sectors. In line with its Private Financing Initiative (PFI) strategy, the Government has identified RM20 billion (US$5.44 billion) worth of build-lease-transfer projects that will be financed by the Employees Provident Fund, among others and leased to the Government. In addition, a RM5 billion PFI Facilitation Fund will be established to support and enhance private sector projects with wider economic spin-offs, for example, through the provision of land and basic infrastructure, or the actual purchase or leasing by the Government of units in the developments

- The state of Johor receives an allocation of RM2.3 billion principally to finance infrastructure projects in the strategic South Johor Economic Region (SJER). In addition, RM200 million will be allocated to a "strategic investment fund", to drive key industries in the SJER

- A capital market measure indirectly impacting the property sector is the exempting of Real Estate Investment Trusts (REITs) from income tax with effect from year of assessment 2007, on the condition that they distribute at least 90 percent of their total income. In addition, for five (5) years from 1 January 2007, dividends paid by REITs listed on Bursa Malaysia will be subject to a final withholding tax of 15 percent in the hands of an investor that is not a resident company; 27 percent in the hands of an investor that is a non-resident company; and 20 percent in the hands of a pension fund, collective investment scheme or other person approved by the Minister of Finance

- With effect from year of assessment 2006, it is proposed that the tax treatment of property development and contract project income be addressed by a specific set of regulations to be passed under the Income Tax Act 1967. The regulations will encompass the recognition of income and expense over the life of the project, including necessary revisions in the case of budget deviations, contingencies, etc. For example, an elective carry-back mechanism will be introduced to rationalize the treatment of losses incurred in the latter phases of projects, or expenses incurred during defects liability or warranty periods. It is noted that industry-specific tax regulations as proposed herein are exceedingly rare, the only other example being the Income Tax Leasing Regulations 1986

Other Sectors

- To unleash new engines of growth, the Government has allocated RM3.6 billion to increase productivity and expand marketing capabilities in the agriculture sector; and introduced a raft of new incentives for the biotechnology sector, including technology acquisition and commercialization funds, and enhanced tax benefits

Rakyat (The People)

- The Government has allocated over RM4 billion to rural development projects, including for roads, water and electricity supply, and pre-school education; as well as a further RM578 million for poverty eradication programmes, plus effective subsidies such as the waiver of school examination fees

- Over RM10 billion is allocated for the provision of health facilities and equipment, specialist services, a new hospital in each of Selangor, Kedah and Johor, mobile clinics for remote areas, free medical examinations to help check chronic illnesses, and mammogram subsidies

- To improve public safety, RM4.9 billion is allocated to enhance police operations, including the deployment of 2,000 more patrol cars and 3,000 more police drivers, plus the installation of CCTVs in crime prone areas

- Tax breaks will be allowed (or increased) to individuals for the purchase of personal computers and books, and the receipt of good employee awards

Further Information

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