

Malaysia

The Intersection of Accounting and Taxation in Malaysia

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The article describes the development of accounting and tax law in Malaysia, and discusses the similarities and differences between those two systems.

1. Introduction

As Malaysia was once part of the British empire, Malaysia's tax and accounting systems are largely influenced by the British system. Although profits are determined differently for tax and accounting purposes, intersections of the two systems occur regularly. Although a total harmonization of tax and accounting rules is nearly impossible, experts in these two areas work closely to minimize taxpayers' compliance burden.

The first part of this article explains the evolution of the accounting profession in Malaysia and the due process involved in the development of accounting standards (see section 2.). This part also describes the accounting standards that are used to assess a company's performance (see section 3.). The second part of the article explains how the Malaysian tax system has gone through various developments and changes to arrive at its current state (see sections 4. and 5.). The last part discusses the sources of differences between tax and accounting rules that hinder the total harmonization between the two regimes (see sections 6. and 7.).

2. History of the Accounting Profession and Development of Accounting Standards in Malaysia

In the early years after Malaya's (as it was then known) independence from the British rule in 1957, the preparation of financial statements was largely influenced by the British accounting system ^[1] as a majority of accountants were trained in the United Kingdom and Australia during that time. ^[2] Furthermore, although Malaya was politically independent, its economy was still dominated by the British, particularly through large British corporations, such as Guthrie and Sime Darby. ^[3] The existence of these British corporations ensured the continuation of the British accounting system and its auditing practice.

Prior to 1997, the development of accounting standards was left to the accounting profession. There are two accounting bodies that govern the accounting profession in Malaysia. The Malaysian Institute of Certified Public Accountants (MICPA) ^[4] was established in 1958 as a self-regulating professional body to provide technical guidance and training to its members and to conduct professional examinations for locally trained professional accountants. ^[5] At the time of its establishment, MICPA had 20 members, all of whom had received education and training overseas. ^[6]

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1. A.M. Ali, T.H. Lee & B. West, *External Influences on the Development and Professionalisation of Accounting in Malaysia, 1957 – 1969*, paper presented at the 2008 Accounting and Finance Association of Australia and New Zealand Conference, Sydney, Australia (6-8 July 2008), pp. 26-27.
2. S.D. Susela, "Interest" and Accounting Standard Setting in Malaysia, 12 Accounting, Auditing and Accountability Journal 3, p. 361 (1999).
3. Ali, Lee & West, *supra* n. 1, at p. 10.
4. Originally known as the Malayan Association of Certified Public Accountants, which changed its name to the Malaysian Association of Certified Public Accountants in 1964. In 2002, its name was again changed to the Malaysian Institute of Certified Public Accountants.
5. S. Mohd Sood, *Setting the Financial Accounting Standards in Malaysia: The Malaysian Accounting Standards Board (MASB) and the Accounting Profession 1997-1999*, p. 6, Master Thesis, Lincoln University (2006), available at http://researcharchive.lincoln.ac.nz/dspace/bitstream/10182/2260/5/sood_mcm.pdf.
6. T. Mohd Iskandar & H. Pourjalali, *Cultural Influences on the Development of Accounting Practices in Malaysia*, 8 Asian Review of Accounting 2, p. 129 (2000).

In 1967, the Malaysian Institute of Accountants (MIA) was founded as a statutory body under the Accountants Act 1967 to regulate and develop the accountancy profession in Malaysia. [7] Under this Act, only members of the MIA are allowed to use the title “accountant”. Thus, everyone who wishes to be an accountant must register as a member, even though he may already be a member of a professional accounting body such as the Association of Chartered Certified Accountants (ACCA), the Institute of Chartered Accountants of England and Wales (ICAEW) or even the MICPA. During the first 20 years after its formation, the MIA developed very slowly and functioned only as a body that registers practicing accountants until it was reactivated in 1987. [8]

As the MIA failed to perform its function as the regulator of the accounting profession, the MICPA continued to be predominant in the standard setting process. [9] After the International Accounting Standards (IASs) were first published in 1975 by the International Accounting Standards Committee (IASC), the MICPA carried out the role of reviewing these standards for their adoption as approved accounting standards in Malaysia. The MICPA started to adopt IASs as approved accounting standards in 1977. [10] In areas where no IAS was applicable or an IAS was contrary to local legislation, the MICPA issued its own guidelines, known as Malaysian Accounting Standards (MASs), to be followed by its members. [11]

When the MIA was reactivated in 1987, it accepted all accounting standards previously approved by the MICPA. Between 1987 and 1992, the MIA and the MICPA worked together through a joint committee on the adoption of IASs and on the issuance of MASs in areas where no IASs were applicable. [12] The joint committee was dissolved in 1992 after a dispute between the two bodies regarding the adoption of MAS 6 Accounting for Goodwill. The MIA was in favour of the adoption of the standard, while the MICPA chose to defer it. With two different standpoints, local accountants were left confused. [13]

Following the dispute between the two accounting bodies, the government decided to take the standard setting activity out of the hands of the profession. In 1997, under the newly enacted Financial Reporting Act 1997, [14] the Malaysian Accounting Standards Board (MASB) was established as an independent standard setting body. The board consists of eight members who have knowledge and experience in the financial reporting field. Under the same legislation, the Financial Reporting Foundation (FRF) was created as a trustee body with the function to oversee the operation of MASB. The FRF is not involved in the standard setting process. The FRF has 12 members, who include representatives from various government bodies, public listed companies, public accounting firms and the MIA itself. [15]

The new legislation has also made it compulsory for financial statements to be prepared in accordance with approved accounting standards. Previously, the accounting standards issued by the MIA and the MICPA were binding only on their members (i.e. the accountants). In the case of non-compliance, these accounting bodies could take disciplinary action against their members. However, the directors of companies were not held responsible. Following the enactment of the Financial Reporting Act 1997, the Companies Act 1965 was also amended. [16] The amendment required all companies to comply with approved accounting standards and placed responsibility on the directors.

Since its establishment in 1997, the MASB has issued its own accounting standards, known as MASB standards. These accounting standards are consistent with IASs (except for locally developed standards), but the MASB has improved their clarity by including explanations, guidance and examples. [17] In 2001, as a result of a restructuring, the IASC was replaced by the International Accounting Standards Board (IASB). The IASB has issued new international financial reporting standards (IFRSs) to replace IASs. Many countries have already adopted or are in the process of adopting the IFRSs.

7. MIA, *About MIA*, www.mia.org.my/new/about.asp.

8. Susela, *supra* n. 2, at p. 362.

9. Susela, *supra* n. 2, at p. 362 and n. 5, p. 7.

10. S.M. Saudagaran & J.G. Diga, *The Institutional Environment of Financial Reporting Regulation in ASEAN*, 35 *The International Journal of Accounting* 1, p. 7 (2000).

11. Susela, *supra* n. 2, at p. 363.

12. For example, MAS 1 Earnings Per Share, MAS 2 Accounting for Acquisition and Mergers, MAS 3 Accounting for General Insurance Business, MAS 5 Accounting for Aquaculture and MAS 7 Accounting for Property Development.

13. Susela, *supra* n. 2, at pp. 363-366.

14. MY: Financial Reporting Act 1997, sec. 26D, National Legislation IBFD.

15. MASB, *Financial Reporting Foundation*, www.masb.org.my/index.php?option=com_content&view=article&id=1&Itemid=5.

16. MY: Companies Act 1965, sec. 166A, National Legislation IBFD.

17. MASB, *MASB Issues 10 Revised Accounting Standards and New Accounting Framework*, Press Release (15 June 2007), available at www.masb.org.my/index.php?option=com_content&view=article&id=525:10-revised-accounting-standards&catid=37&Itemid=37.

Malaysia has joined other countries in adopting the IFRSs, and attempts to achieve full convergence have been taking place since 1 January 2012. [18] Since January 2006, the MASB has been revising its accounting standards by removing the enhancements that were incorporated into the MASB standards, so that the wording of those standards will be identical to that of the IFRSs. The name used for the standards has also been changed from MASB standards to Malaysian Financial Reporting Standards (MFRSs). Most IFRSs have been adopted since then, except for a few standards that were not previously adopted by the MASB. [19]

Together with the adoption of the IFRSs, Malaysia has also adopted the two-tier financial reporting system applied by the IASB. The two-tier system allows the use of a different set of accounting standards, known as Private Entity Reporting Standards (PERs), by private entities. These private entities are privately run small and medium-sized companies. The use of PERs, which are much simpler than IFRSs, can reduce the compliance burden of private entities. However, those entities are given the choice to use either PERs or IFRSs. Whichever standards are chosen, they need to be applied consistently and in their entirety in the preparation of financial statements. [20]

3. The Due Process for Development of Accounting Standards

Since their introduction in the 1970s, the standards have been regularly reviewed and updated to ensure high quality financial reporting that is appropriate for the fast-changing business environment. The standard setting process normally takes more than one year before a standard can be officially published. An important part of the process is to invite all interested parties, including auditors, company directors, investors, academics, accounting bodies, analysts, the government and interested individuals, to take part by giving their views and comments on the new proposed standard. This is to ensure that the new standard is accepted by all parties and to minimize post-implementation issues. As the role of the IASB is to develop a globally accepted set of standards, it has a challenging responsibility to accommodate comments of all interested parties in the standard.

The due process starts when the IASB identifies an issue that requires a new standard or an alteration to an existing standard. This issue might be raised by the IASB staff or any external parties. After investigations by its staff and consultations with the IFRS Advisory Council and other standard setting bodies, the IASB decides whether to proceed with the issue or not. [21]

Once an issue has been included on the IASB's active agenda, a working group may be established. The selection of the members of a working group depends on how extensive the issue is. If the IASB decides not to establish a working group, the reason must be stated. The working group may also be set up as a joint project with other standard setting bodies. [22]

The next stage in the standard setting process is the development and publication of a discussion paper. This stage is not mandatory for the IASB; however, it is a normal practice and the IASB needs to state a reason if it is to be omitted. The discussion paper is the first publication released to the public with regard to an issue, and the public is invited to give comments and recommendations. Normally, the time allowed for submissions is 120 days, but it may be longer. All comments are analysed by the IASB and posted on its website. If further comments are required, the IASB may conduct field visits, or arrange public hearings and roundtable meetings with interested parties. [23]

Based on comments received in response to the discussion paper, the next stage is the publication by the IASB of an exposure draft. This is a mandatory stage. An exposure draft is published as a proposed standard and follows the format of an actual standard. The draft may also include other information that can assist readers to better understand the issue, such as application and implementation guidance, the basis for conclusions on proposals and dissenting views. Again, at this stage, the public is invited to give comments, usually within 120 days. All comments and a summary are posted on the website. Field visits, public hearings and roundtable meetings are arranged, if necessary, to acquire more feedback.

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18. MASB, *Malaysian Financial Reporting Standards: Effective Date and Applicability*, available at www.masb.org.my/index.php?option=com_content&view=article&id=1649&Itemid=14.
19. C. Canham, *Malaysian Standard Setter to Complete IFRS by 2012*, *The Accountant* (15 Aug. 2008), available at www.theaccountant-online.com/news/malaysian-standard-setter-to-complete-ifrs-adoption-by-2012.
20. MASB, *MASB: FRS Now Optional for Private Companies*, Press Release (23 Feb. 2006), available at www.masb.org.my/index.php?option=com_content&view=article&id=564:frs-now-optional&catid=38:press-release-2006&Itemid=37.
21. IFRS Foundation, *Due Process Handbook for the IASB* (Feb. 2012), paras. 19-26.
22. Id., at paras. 27-29.
23. Id., at paras. 30-37.
24. Id., at paras. 38-44.

The IASB may issue a second exposure draft if there are unresolved issues in relation to the first one, following the same due process. Before continuing to draft an IFRS, the IASB is required to prepare a project summary and feedback statement. This statement gives direct feedback to comments received from the exposure draft and explains the most significant issues raised and how they were responded to. In addition, the IASB also prepares an analysis of the possible effect of the implementation of the new IFRS, which includes implementation costs, ongoing costs and how the new IFRS can improve the quality of financial statements. After all issues have been resolved and a conclusion can be reached, an IFRS can be drafted. The draft IFRS is reviewed by an external party, normally by the IFRS Interpretations Committee, [25] to prevent any “fatal” flaws. It is also posted on the website of the IFRS Foundation and the IASB, but available only to registered subscribers. Finally, after the IASB members have balloted in favour of the publication, the IFRS is issued. The project summary and feedback statement and analysis of possible effects are published afterwards. [26]

After the issuance of an IFRS, the IASB holds various events to cater for any post-implementation problems. These include meeting with interested parties, including other standard setting bodies, and educational activities to assist taxpayers to better understand the new standard. Ongoing reviews are held within two years after implementation to detect any unexpected complications. [27]

4. The Evolution of the Malaysian Income Tax System

The income tax system in Malaysia is significantly influenced by the British tax system because Malaysia was once under the British colonial rule. Before examining how the Malaysian income tax system evolved to reach its current form under the Income Tax Act 1967 (MITA), [28] it is useful to review briefly the history of Malaysia during the colonial period.

British administration came to Penang as early as in 1786. [29] By the end of the 19th century, the British controlled many states in Malaya (currently Peninsular Malaysia). These states were grouped into three categories. The Straits Settlements, established in 1824, [30] were governed directly by the British Colonial Office with a British governor. [31] The Federated Malay States, formed in 1896, maintained the Malay Kings as the rulers in each state, but they received British State Residents and were headed by a Resident-General. [32] The Unfederated Malay States received British advisers, but they were not tied to a centralized government, so that the Malay Kings in these states had greater power and were more independent. [33] The British government proposed to gradually combine these three groups of states. However, the plan was suspended when the Japanese invaded Malaya in 1941. [34] After the end of World War II, the British returned to Malaya and, in 1946, proposed the idea of a Malayan Union, which would combine all states including the Straits Settlements (except for Singapore), Federated Malay States and Unfederated Malay States under one central administration. The idea of Malayan Union was strongly opposed (for reasons other than tax) and was eventually dropped. Two years later, it was replaced by the Federation of Malaya, under which all states except for Singapore were centralized. [35]

The very first attempt by the British to introduce income tax was made in the Straits Settlements, the area in which they had absolute control. A draft bill on the implementation of income tax was presented to the Straits Settlements Legislative Council in 1910. However, due to strong opposition from the public, the bill was withdrawn. Nevertheless, the British government believed that income tax was a proper way to raise revenue and, hence, in 1916, proposed another income tax bill. This time, the tax was successfully implemented between 1917 and 1919 as a temporary war tax to help support efforts in the war conditions encountered by the British. In 1920, the War Tax Ordinance 1919 was converted into the Income Tax Ordinance, but the tax collected was still used to support the war efforts. Owing to strong opposition, the *Income Tax Ordinance* was repealed in 1922. No form of income tax was introduced in Malaya until 1940. [36]

25. The IFRS Interpretations Committee is the interpretative body of the IASB. Its function is to review accounting issues of widespread importance that have arisen from IFRSs and to publish authoritative guidance, known as IFRIC Interpretations.

26. IFRS Foundation, *supra* n. 21, at paras. 45-51 and 76-83.

27. *Id.*, at paras. 52-53.

28. MY: Income Tax Act (MITA) 1967, National Legislation IBFD.

29. N.J. Ryan, *The Making of Modern Malaya: A History from Earliest Times to Independence* p. 80, 2nd ed. (Oxford University Press 1965).

30. *Id.*, at p. 92.

31. *Id.*, at p. 110.

32. *Id.*, at pp. 133-135.

33. *Id.*, at pp. 138-142.

34. *Id.*, at pp. 160-162.

35. *Id.*, at pp. 191-194.

36. A.A. Che Azmi, *The Development of the Relationship between Accounting and Taxation during the Colonial Period: The Case of Malaysia*, paper presented at the 2007 Accounting, Business and Financial History Conference, Cardiff Business School, 10 and 11 Sep. 2007.

In 1940, the British administration announced another plan to impose income tax. Again, there was opposition from the public. The proposal was abandoned, but only for a short period. Later in the same year, the government formed a joint committee to draft tax bills for the Straits Settlements and the Federated Malay States. The draft was based on the War Tax Ordinance 1919 and intended to be imposed for only one year, assuming annual adoption of new tax bills. Separate bills, effective 1 January 1941, were passed for the Straits Settlements [37] and the Federated Malay States. [38] Their contents were identical in many respects. The bills for 1942 were drafted and passed, but, due to the invasion by the Japanese, they were short-lived. However, it was reported that the government managed to collect some income tax in the Straits Settlements during the Japanese occupation period. [39]

After the end of the Japanese occupation in 1945, [40] the British administration once again sought to introduce income taxation. However, due to instability of the economy during that time, the plan was deferred. [41] In 1947, the British government appointed R.B. Heasman, a tax expert from the British Inland Revenue Office, to investigate whether income tax was a practical tax policy for Malaya and Singapore. [42] His comprehensive report, known as the Heasman Report, was published in August 1947 and concluded that an increase in revenue was “urgent, important and vital” and that income tax was the only way to achieve this. [43] Eventually, the Income Tax Ordinance 1947, based on the Model Colonial Territories Income Tax Ordinance 1922, was passed for Malaya and Singapore, effective 1 January 1948. [44] Heasman himself was appointed as the first Comptroller for Income Tax for Malaya and Singapore. [45]

The formation of Malaysia in 1963 saw Malaya combined with Sabah and Sarawak from Borneo and Singapore (which left the federation in 1965). Since Sabah and Sarawak had their own tax legislation, [46] measures were taken to harmonize the tax system. Subsequently, the MITA 1967 (effective from 1 January 1968) was passed and it still remains in effect to this day. [47]

The collection of income tax was administered by the Income Tax Department, renamed the Inland Revenue Department after Malaya’s independence in 1957. Despite independence from Britain, the post of Comptroller General continued to be held by foreigners until 1967, when a Malaysian was appointed as the Director General of the Inland Revenue Department. In 1996, following the enactment of the Inland Revenue Board of Malaysia Act 1995, the department was upgraded to a statutory body and its name changed to the Inland Revenue Board of Malaysia (IRBM). [48]

5. The Income Tax System in Malaysia

5.1. General principles

Two types of taxes are levied in Malaysia: direct and indirect taxes. The collection of direct taxes, which include individual income tax, corporate tax, real property gains tax and stamp tax, is controlled by the IRBM. Indirect taxes, which consist of sales tax, service tax, customs duties and excise duty, are governed by the Royal Malaysian Customs Department. Customs duties comprise import and export duties.

In Malaysia, income tax is assessed on a territorial basis. Only income accruing in or derived from Malaysia is chargeable to tax. Foreign income is not taxable. This rule is applicable to both resident and non-resident persons and companies with the exception of resident companies involved in banking and sea and air transportation. [49] These companies are assessed on a worldwide basis, which means all income, wherever derived, is chargeable to tax in Malaysia. [50]

37. MY: Straits Settlements Ordinance No. 3 1941.

38. MY: War Tax Enactment No. 5 1941.

39. Che Azmi, *supra* n. 36, at pp. 6-7.

40. Ryan, *supra* n. 29, at p. 188.

41. Che Azmi, *supra* n. 36, at 37, 8.

42. The Straits Times (Singapore), *Income Tax Man Named*, p. 5 (3 Jan. 1947), available at <http://newspapers.nl.sg/Digitised/Article.aspx?articleid=straitstimes19470103.2.67>.

43. The Straits Times (Singapore), *The Heasman Report – 1*, p. 4, (20 Aug. 1947), available at <http://newspapers.nl.sg/Digitised/Article.aspx?articleid=freepress19470820.2.43>.

44. V. Singh, *Veerinder on Taxation* p. 5, vol. II (Arah Publications 2008).

45. The Straits Times (Singapore), *Tax Officers Gazetted*, p. 5 (22 Feb. 1948), available at <http://newspapers.nl.sg/Digitised/Article.aspx?articleid=straitstimes19480222.2.60>.

46. Income Tax Ordinance 1956 of Sabah, Inland Revenue Ordinance 1960 of Sarawak.

47. Che Azmi, *supra* n. 36, at p. 12.

48. IRBM, *IRBM Annual Report 2008*, pp. 18-19.

49. Para. 28, sch. 6 MITA 1967.

50. Sec. 60C and 54(2)(a) MITA 1967.

Resident individuals are taxed at progressive tax rates (in 2013, the tax rates are between 0 and 26%). Non-resident individuals are taxed at a flat rate of 26%. Effective 2009, both resident and non-resident companies are taxed at a flat rate of 25%. Resident companies with paid capital not exceeding MYR 2.5 million enjoy a lower tax rate of 20% for the first MYR 500,000 of taxable income.

The determination of resident status for individuals is based on a quantitative approach, depending on the number of days spent by the individual in Malaysia. ^[51] A company is resident in Malaysia if, at any time during the fiscal year, the management and control of its business or any of its businesses are exercised in Malaysia. ^[52] The term “management and control” normally refers to meetings of the board of directors. However, as the term is not specifically defined in the legislation, its interpretation derives from case law. ^[53] The advantages of being a resident company include: entitlement to receive investment incentives and enjoyment of the benefits of tax treaties with other countries.

5.2. Determination of taxable income for companies

The corporate tax rate of 25% is imposed on taxable income. Section 4 of the MITA 1967 specifies the following types of income that are chargeable to income tax, applicable to both resident and non-resident taxpayers:

- gains or profits from a business;
- gains or profits from an employment;
- dividends, interest or discounts;
- rents, royalties or premium;
- pensions, annuities or other periodical payments not falling under any of the foregoing categories; and
- gains or profits not falling under any of the foregoing categories.

In addition, section 4A of the MITA 1967 specifies three special classes of income that are taxable if derived by a non-resident person:

- amounts paid as remuneration for services rendered by the person or his employee in connection with the use of property or rights belonging to, or the installation or operation of any plant, machinery or other apparatus purchased from, such person;
- amounts paid as remuneration for technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme;
- rent or other payments made under any agreement or arrangement for the use of any moveable property.

Expenses that are allowed to be deducted from these types of income are based on the general deduction rule as stipulated in section 33(1) of the MITA 1967:

Subject to this Act, the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person from that source for that period all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of gross income from that source.

Apart from the general deduction rule, there are allowances and other deductions that must be taken into account before arriving at taxable income. The computation of taxable income involves general adjustments shown in the following table.

Table: The computation of taxable income

Gross income	
<i>Less:</i>	Allowable expenses (sec. 33(1) MITA 1967)
	Double deduction of expenses
	Special deductions (sec. 34(6) MITA 1967)

^{51.} Sec. 7 MITA 1967.

^{52.} Sec. 8 MITA 1967.

^{53.} For further discussion on this issue, see Singh, *supra* n. 44, at pp. 273-279.

Adjusted income (sec. 33 MITA 1967)	
Add:	Balancing charges
Less:	Capital allowances (sch. 3 MITA 1967)
	Balancing allowances
Statutory income (sec. 43 MITA 1967)	
Less:	Pioneer status income exemption/Investment tax allowance (Promotion of Investments Act 1986)
	Reinvestment allowance (sch. 7A MITA 1967)
	Unabsorbed business losses from previous years
Add:	Statutory income from other sources
Aggregate income (sec. 43 MITA 1967)	
Less:	Current-year business losses
	Approved donations and business <i>zakat</i> ^[54]
	Pre-operational business expenses
Taxable income (sec. 44 MITA 1967)	

54. Zakat is a religious charity donation that must be paid by Muslims. Under section 44(11A) of the MITA 1967, a company that paid business zakat to an appropriate religious authority is eligible for a deduction of an amount limited to 2.5% of the aggregate income; 2.5% is the standard rate used to calculate zakat payable.

Apart from the general adjustments mentioned above, there are also specific adjustments made at different stages of the calculation of taxable income or tax payable. Since tax law does not use any accounting rules, there is no direct link between net accounting profits and taxable income.

5.3. Sources of tax law

There are three sources of tax law in Malaysia. The first one is the tax legislation (written formal law). This is the law that has been enacted by the parliament. The main laws within the control of the IRBM include: the MITA 1967, Promotion of Investments Act 1986, Real Property Gains Tax Act 1976, Petroleum (Income Tax) Act 1967, Stamp Act 1949 and Labuan Business Activity Tax Act 1990. In addition, there is also secondary legislation, such as exemption orders, tax rules and regulations that are tabled by the Minister of Finance in the yearly Budget speech. ^[55]

The second source is the case law (unwritten formal law), which assists in the interpretation of the legislation. There are many undefined terms in the MITA 1967 (for example, “income” and “plant”). What falls within the scope of these terms is determined by the judges. On some occasions, different judges may have different opinions. Furthermore, Malaysia also applies the doctrine of precedent, where, in cases with similar circumstances, courts are bound to apply their own previous decisions and the decisions of higher courts. Given Malaysia’s British colonial history, it is common for Malaysian courts to refer to cases from other Commonwealth countries, such as Singapore, Australia, New Zealand, Hong Kong and the United Kingdom itself. However, Malaysian courts are not legally bound to apply foreign judgments, except for decisions of the Privy Council prior to 1985. Effective 1 January 1985, civil appeals, including tax appeals, to the Privy Council were abolished. Therefore, decisions made by the Privy Council after this date have no binding effect on Malaysian courts.

In Malaysia, any dispute between a taxpayer and the Director General of Inland Revenue (DGIR) is first heard by the Special Commissioners of Income Tax (SCIT), a court that deals specifically with income tax matters. An appeal from a decision of the SCIT is brought before the High Court, and a further appeal may be heard by the Court of Appeal. The

55. Singh, *supra* n. 44, at pp. 18-19.

highest court in the hierarchy is the Federal Court, which hears appeals from decisions made by the Court of Appeal. Decisions of the Federal Court are final. No further appeals are allowed.

The informal source of tax law is the administrative practice of the IRBM. This includes the IRBM's assessment and review procedures and day-to-day practice. It also includes various rulings and guidelines issued by the IRBM. [56] The most common type of rulings is the public ruling, which describes how a particular tax law is interpreted by the DGIR, together with the policy and procedure that should be applied. [57] The DGIR is empowered, under section 138A of the MITA 1967, to issue a public ruling and apply it accordingly. The public ruling does not have any legal effect; [58] however, it has become "accepted law". [59] Nevertheless, if the matter is brought to court, it is for the court to interpret the law based on the legislation and case law.

6. Using Accounting Income To Determine Taxable Income

Income tax is charged on taxable income. The first step to arrive at taxable income is to determine adjusted income. Adjusted income is derived by deducting from gross income all expenses and costs incurred to earn the gross income. This requirement is laid down in section 33(1) of the MITA 1967.

Under accounting law, the term profit is defined as "the residual amount that remains after expenses (including capital maintenance adjustments, where appropriate) have been deducted from income". [60] The adjusted income for taxation purposes does not significantly differ from the accounting profit. They both result from deducting expenses from gross income. Yet, in almost all cases, the accounting profit must be adjusted to arrive at taxable income. Section 33(1) of the MITA 1967 contains the phrase "[s]ubject to this Act", which means that income is calculated not only by deducting all expenses incurred, but it must also take into account all other provisions of the MITA 1967.

The effort to promote accounting standards as the basis for the calculation of corporate income tax is not new. It started many years ago, advocated mainly by the accounting community and some parts of the legal community. [61] The accounting community argues that, since accounting income is convincing enough for investors and creditors, it should also be convincing enough for tax assessment. Furthermore, the use of accounting income for tax purposes could simplify the tax system and minimize compliance costs, thereby reducing tax avoidance. [62] However, there are many dissenting views, most of which come from experts in economics and law. [63] The reasons for those views include the different objectives of accounting and tax rules, and the issue of timing and uncertainties in accounting provisions. There is also concern about the role of the private organization setting the accounting standards, which would play the government role of determining what should and should not be taxed. These reasons are discussed in section 7.

7. Inherent Differences between Accounting Income and Taxable Income

Although the goal of both accounting and taxation is to determine net income, it is almost impossible to totally align those two systems. There are five reasons why accounting income and taxable income cannot be aligned:

- (1) *Different objectives.* Since accounting and taxation have different objectives, their designs are also different to enable them to meet their particular objectives. The main objective of financial statements is to show a company's financial performance and position to shareholders, potential investors and creditors. [64] Generally, what such parties need to know is the current and future performance of the company to enable them to assess the company's ability to give a high return on investment and to pay its debts. [65] Therefore, accounting standards are designed to provide trusted

56. Id., at p. 20.

57. IRBM, *Public Rulings* (12 Apr. 2011), available at www.hasil.gov.my/goindex.php?kump=5&skum=5&posi=3&unit=1&sequ=1.

58. MY: HC, 2010, *KPHDN v. NV Alliance Sdn Bhd* ((2010) MSTC 30-015).

59. Singh, *supra* n. 44, at p. 20.

60. IFRS Foundation, *The Conceptual Framework for Financial Reporting* (Nov. 2011), para. 4.60.

61. See, for example, K.L. Wertz, *A Book Income Tax: First Order Computations*, Proceedings of the 91st Annual Conference on Taxation, Austin, Texas, (8-10 Nov. 1998); H. Dubroff, M.C. Cahill & M.D. Norris, *Tax Accounting: The Relationship of Clear Reflection of Income to Generally Accepted Accounting Principles* 47 Albany L. Rev. (1983); A. de Zilva, *The Alignment of Tax and Financial Accounting Rules: The Case for a New Set of Common Rules* 1 Journal of the Australasian Tax Teachers Association 1 (2005); K. Holmes, *Should Accountants Determine How Much Tax We Pay?: International Accounting Standards vs Taxable Income and Capital Gains* 14 New Zealand Journal Taxn. L. & Pol. J. 3 (2008).

62. Holmes, *supra* n. 61, at p. 325, and De Zilva, *supra* n. 61, at pp. 67-69.

63. See for example C. Johnson, *GAAP Tax*, 83 Tax Notes (1999); H.M. Weinman, *Conformity of Tax and Accounting* 59 The Tax Magazine 7 (1981); J. Freedman, *Aligning Taxable Profits and Accounting Profits* 2 eJournal of Tax Research 1 (2004); J. Freedman, *Financial and Tax Accounting: Transparency and "Truth"*, Legal Studies Research Paper Series Working Paper No 02/2008.

64. IFRS Foundation, *supra* n. 60, at para. OB 2.

65. Id., at para. OB 16.

and reliable information about the company's financial performance and position that can also be used to safeguard investors and creditors from fraud on the part of the company. In contrast, the objective of taxation is to raise revenue for the government. Tax revenue is used to fund government expenditure and finance government projects. The higher the spending, the more tax revenue needs to be collected. It is up to the government to levy tax on any basis it chooses and to disregard income or expenses where it thinks it is appropriate. Nevertheless, the government must consider the principles of fairness and ability-to-pay when setting the tax rules to make sure everybody pays their fair share of tax.

- (2) *Timing differences.* One of the main factors behind the different rules on profit determination is that of timing. Accounting principles emphasize the matching principle, which requires expenses to be matched with income generated by those expenses, while tax rules emphasize certainty and income-producing requirements, which delay and deny the recognition of some expenses. Further differences include: a different useful life to calculate accounting and tax depreciation, different point of recognition for income and expenses, and a different treatment for expenses incurred before commencement and after cessation of business.
- (3) *Tax expenditures.* Besides being the source of government revenue, taxation is also a means to support the government's economic and social objectives. Hence, various kinds of tax expenditures and negative tax expenditures are embedded in the tax system. Examples of the former include: income exemptions and double deductions, whereas examples of the latter include denial of deductions. On the other hand, the purpose of accounting rules is to measure business income and not to achieve any economic and social objectives.
- (4) *Tax minimization.* Taxpayers seeking to minimize tax liabilities engage in transactions to shift income to a related company with losses or in a low-tax jurisdiction. Tax law may have rules that ignore these transactions, but they will be respected and recorded for accounting purposes as accounting is not concerned with the taxpayer's motive behind a transaction.
- (5) *Private body.* Accounting standard setting body must be a private organization to maintain its independence and objectivity without influence from external parties, including the government. [66] Tax rules are formulated by the government, which would not let a private body control the formulation of the law.

In Malaysia, the main associations of accountants, the MIA, the MICPA and the Chartered Tax Institute of Malaysia (CTIM), are working together as part of the Joint Tax Working Group on Financial Reporting Standards to discuss tax implications resulting from the adoption of IFRSs. [67] The group produces discussion chapters which include proposals for tax changes to ease taxpayers' compliance burden.

While complete harmonization is not possible, there are some features of the Malaysian tax system that should be aligned with accounting practices. Some provisions in the Malaysian tax legislation are outdated and do not reflect the reality in the present world. For example, many problems derive from the "wholly and exclusively incurred in the production of gross income" rule of section 33(1) of the MITA 1967, inherited from the British tax system, which disqualifies many business expenses as tax deduction. [68] In these cases, accounting practices offer a better method of measuring business income and ascertaining corporate tax. The tax authorities should refer to accounting practices to make sure tax rules are up to date with today's fast-changing and complex business world.

8. Conclusions

The use of accounting standards to measure company performance receives worldwide recognition. In Malaysia, accounting standards are recognized by the government and are legally enforced. Generally, stakeholders, especially capital providers, accept financial statements as a reliable source of information to make financial decisions. The thorough process involved in the preparation of standards is evidence of their high quality.

The Malaysian income tax system is based on the British tax system, and, thus, has some similarities with the tax systems of other Commonwealth countries. While the legislation appears fundamentally different, Malaysian courts have used British concepts to interpret Malaysian law and, in this way, the fundamental British principles are reflected in Malaysian tax law, particularly in the characterization of gains as capital gains or income receipts. The Malaysian tax system is put into practice based on the interpretations of the IRBM.

66. INTOSAI Subcommittee on Accounting and Reporting, *The Importance of an Independent Standard-Setting Process*, 38 Intl. Gov. Audit. J. 2, pp. 19-20 (2011).

67. MIA, *Joint Tax Working Group on Financial Reporting Standards*, available at www.mia.org.my/new/psp_taxation_joint.asp.

68. K.C. Keat, *Tax Deductibility of Business Expenses*, available at www.pwc.com/my/en/issues/tax-deductibility.jhtml.

Although both accounting and tax rules focus on the determination of net income, they are two separate systems with different objectives that could not, and should not, be totally aligned. Nevertheless, as the two systems are closely related to each other, any effort to reduce the gap must be welcomed, as long as the objectives of each system remain upheld.