

IMPACT OF SINGLE-TIER TAXATION SYSTEM ON DIVIDEND RETURNS OF INDIRECT PROPERTY INVESTMENTS IN MALAYSIA

Dr. Ting Kien Hwa

Center for Real Estate (CORE)

Faculty of Architecture, Planning and Surveying

Universiti Teknologi MARA

40450 Shah Alam, Selangor

Email: tingkienhwa@yahoo.com

Abstract

The Budget 2008 has proposed to replace the existing dividend imputation system with a single-tier dividend tax system as part of the tax reform process to achieve efficiency and simplicity. The adoption of single-tier system has important implications for both companies and investors receiving dividends from their share investments.

The new single-tier dividend system is compared with the former two-tier dividend imputation system to examine the tax effects on dividends declared by listed companies of the property, hotel and plantation sectors of Bursa Malaysia.

The after-tax dividend income under the single-tier system is also compared with the holding tax imposed on REIT income to examine the relative attractiveness of different indirect property investment options i.e. shares in the property, hotel and plantation sectors versus REITs.

Keywords: single-tier dividend system, indirect property investment, REITs

Introduction

In general, there is a growing international trend to integrate corporate and personal tax so that double taxation is avoided. The Budget 2008 announced that as of 1st January 2008, the tax treatment of corporate dividends will be changed from the dividend imputation system to single-tier system. The single-tier or one-tier system is a move to reform the current imputation corporate tax system towards the direction of simplifying the Malaysian tax system.

The changed in the taxation on dividends will have implications on individual investors, institutional investors and

companies that received dividends from listed companies and for companies that make dividend payments.

The dividend imputation system

Under the imputation system, a company pays tax on its annual chargeable income. The tax paid is credited into its imputation account (i.e. Section 108 account). The company can then franks dividend out of the imputation credit. The company can only pay franked dividends based on the credit it has accumulated. A shareholder who receives the dividend will need to include the dividend as part of his income in computing his taxable income. The tax paid by the company is given as a credit

to the shareholder. In another words, the shareholders are taxed on gross dividend with tax credit given. For shareholder who is not liable to income tax e.g. pensioners and retirees, the full credit would be refunded to him.

The system is costly as it involves significant costs of administration to ensure tax compliance to keep track of taxes paid. Another disadvantage of this system is that non-resident investors do not benefit from the tax credits enjoyed by the resident investors.

The dividend imputation system is currently still applicable until 31st December 2013 on all other listed companies apart from REITs in Bursa Malaysia.

New single-tier dividend system

Under the single-tier system, tax is only levied on the profits of the company and is then free to distribute the after-tax profits whenever it wishes without having to link the dividends to the corporate tax that the company has paid. The dividends received by the shareholders are exempted from income tax. For implementation, the single-tier system is under a six-year transitional period (1st January 2008 to 31st December 2013) to allow companies to use their existing tax credits to declare dividends. Companies that wish to pay single-tier dividends are required to exercise a one-time option in writing which is irrevocable. Table 1 shows the characteristics of the single-tier system and the imputation system. Table 2 shows the after tax dividend income under the two systems.

Advantages of the single-tier system

This system is administratively easier to monitor. Shareholders do not need to report such corporate dividends and claim

corresponding tax credits. The system achieves simplicity resulting in efficiency savings for both businesses and the tax authority. It plugs up tax leakages since no tax refunds are made.

The significant feature of the single-tier system is that there is no restriction on the flow of dividends to shareholders and capital profits can be flowed out to shareholders without any hindrance. This feature would appeal to regional and multi-national companies seeking a holding company location in Malaysia.

Disadvantages of the single-tier system

The disadvantage of this system is that for taxpayers, whose marginal tax is lower than the corporate tax rate will no longer receive a refund of the differential taxes paid. For example, individuals on a top marginal personal tax rate of 28% as against a 25% corporate tax rate in 2009, the individual investors would suffer from a 3% tax differential. These individuals are disadvantaged as they will not be able to get refunds of the corporate tax on the dividends.

Under the single-tier system, all investors will pay tax at the highest corporate tax rate i.e. 26% in 2008 and 25% in 2009. In particular, this new system is disadvantageous to certain groups of investors identified below:

- (a) for investors whose marginal tax is lower than the corporate tax rate.
- (b) charities, pension funds and other tax-exempt bodies that do not pay any taxes.
- (c) investors who borrow to finance the purchase of their share investment will not be entitled to any tax relief for the funding costs e.g. interest expense.

Table 1: Characteristics of the dividend imputation system and single-tier system.

Features	Imputation system	Single-tier system
(a) Dividends	Dividends are taxable on the recipients.	Dividends are exempt from income tax.
(b) Tax credits	Yes	No
(c) Section 108 franking credit	Section 108 franking credits is accumulated from the tax paid by the company.	The company distributing the dividends is free to distribute profits to shareholders as it no longer requires Section 108 franking credits in order to distribute dividends.
(d) Distribution of capital gains as dividends	Dividends cannot be distributed from capital gains received by the company, without suffering tax.	Allows the distribution of capital gains as dividends.
(e) Tax administration	Incur higher compliance and administration costs.	Easier to administer.

Table 2: After tax dividend income under dividend imputation system and single-tier system.

Shareholder	Dividend imputation system		Single-tier system	
	Corporate (RM)	Individual ² (RM)	Corporate (RM)	Individual ² (RM)
Shareholder's dividend income ¹	100	100	100	100
Company tax (26%)	26	26	26	26
Dividend received by shareholder	74	74	74	74
Tax	26	28	0	0
Imputation credit	26	26	Not applicable	Not applicable
Net shareholder tax	0	2	0	0

Note

1 Assuming a dividend of RM100.

2 Assuming the individual has a personal income tax rate of 28%.

(d) all unit trust investors who receive distributions which contained dividends will now suffer tax at the corporate rate.

(b) where an individual investor's marginal rate of tax is at 26%, the investor may find share investments to be less attractive compared to other investment instruments e.g. bank deposits and certain bonds which attract zero percentage tax.

Effect of single-tier system on dividends from indirect property investments

Under the single-tier system, there would be different net tax effects for different individual investors on the dividend income received depending on the individuals marginal rate of tax:

(a) where an individual investor's marginal rate of tax is less than 26% (for year 2008), the investor will not be entitled to a tax refund;

The single-tier system applies equally on indirect property investments in the form of listed companies in the property sector (i.e. listed property development companies and property investment companies), hotel sector and plantation sectors. These listed companies generally have a dividend payout policy and is expected to pay franked dividends under the transitional period. Another reason is that often the

level of a company's dividend payments would correlate with its profitability and the need to retain earnings for future business expansion and for making acquisitions. Under this scenario, it would have accumulated a large tax credit balance which will enable it to continue to pay franked dividends. In addition, a company paying a 10% franked dividend will pay out less cash than it paid a single-tier dividend at the same rate. This is a further reason for these listed companies for not switching to the single-tier system during the transitional period until the due date.

REIT and dividend income

Following the announcement of the Malaysian 2007 Budget on 1st September 2006, unitholders who receive distribution from REIT after 1st January 2007 are subject to their respective tax rates as follows:

- (a) non-corporate investors and local institutional investors are subject to a final withholding tax at the rate of 15% from 2007 to 2011;
- (b) foreign institutional investors are subject to a final withholding tax at the tax rate of 20% from year 2007 to 2011;
- (c) foreign corporate investors are subject to a final withholding tax at the rate of 27%(2007) and 26%(2008);
- (d) local corporate investors are subject to the existing treatment and tax rates. Currently dividends declared by REITs are subject to a withholding tax of 15% for individual and institutional investors. The 15% withholding tax for REITs is lower than the corporate tax rate of 26% in 2008 and 25% in 2009.

Thus among investment options that provide consistent dividend incomes, REITs has a more favourable position since the withholding tax (15%) is lower than the corporate tax (26%) (refer Table 3).

Whilst Table 3 shows a higher after tax dividend income under the single-tier system than the REIT withholding tax regime, however the amount of after tax income of different individual investors may vary as their personal income tax rate differs. Table 4 shows the impact of different personal income tax rate on the after tax income for dividends earned from indirect property investment options under the single tier system and the RIET tax regime.

Results from Table 4 shows that individual REIT investors with an income tax bracket of 24% and below enjoy a higher after tax income of 2.7% to 35.14% higher than dividends received under the single-tier system.

However for individual REIT investors with an income tax bracket of 27% and 28% will suffer from a lower after tax income ranging from 1.35% to 2.7% compared to dividends received under the single-tier system.

Conclusion

Under the single-tier system, investors in indirect property investments in the form of shares in the property, hotel and plantation sectors may receive lesser dividend income from these share investments as shareholders will no longer receive tax credits with their dividend income. This means tax-exempt bodies and individuals will no longer receive such refunds and therefore will suffer from a lower after tax dividend income.

Table 3: A comparison of after tax income on dividends of listed companies under the single-tier system and REIT withholding tax regime.

Shareholder	Single-tier system		REIT withholding tax regime	
	Institutional investor (RM)	Individual ² (RM)	Institutional investor (RM)	Individual ² (RM)
Shareholder's income ¹	100	100	100	100
(a) Company tax (26%)	26	26		
(b) Withholding tax for REIT (15%)			15	15
Dividend received by shareholder	74	74	85	85
Income tax rate	0	0	28	28
Net income	74	74	57	57
Imputation credit	Not applicable	Not applicable	15	15
After tax income	74	74	72	72

Note

1 Assuming a dividend of RM100.

2 Assuming the individual has a personal income tax rate of 28%.

Table 4: A comparison of after tax income for dividends receivable from listed indirect property companies (single tier system) and REITs (REIT tax regime).

PROPERTY SHARES		REIT				
Single tier system (RM)	After tax amount receivable (RM) (a) ¹	Dividend imputation system (RM)	Income tax bracket (%)	After tax amount receivable (RM) (b) ²	Difference (c) = (b) - (a)	Percentage higher (c)/(a) x 100%
100	74	100	Tax exempt	85	11	14.86
100	74	100	0	100	26	35.14
100	74	100	1	99	25	33.78
100	74	100	3	97	23	31.08
100	74	100	7	93	19	25.68
100	74	100	13	87	13	17.57
100	74	100	19	81	7	9.46
100	74	100	24	76	2	2.70
100	74	100	27	73	-1	-1.35
100	74	100	28	72	-2	-2.70

Note

1 Company tax in 2008 is 26%.

2 Withholding tax for REIT is 15%.

3 Appendix 3 shows the chargeable income and personal income tax rate.

When compared to REITs the net after tax amount received by investors with income tax bracket of 24% and below is lesser when their share investments are made in the property, hotel and plantation sectors. But for individual investors with a higher income tax bracket of 27% and 28% will enjoy a higher after tax dividend income under the single tier system compared to the REIT withholding tax regime.

Whilst REIT remains a favourable investment yielding high dividend distributions, a lower withholding tax on distributions by REITs will make REITs a more attractive high yield indirect property investment option.

References

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Appendix 1: Income tax schedule (2007)

Category	Chargeable income range (RM)	Tax rate (%)	Income tax (RM)
A	0 to 2,500	0	0
B	2,501 – 5,000	1	1 – 25
C – D	5,001 – 20,000	3	26 – 475
E	20,001 – 35,000	7	476 – 1,525
F	35,001 – 50,000	13	1,526 - 3,475
G	50,001 – 70,000	19	3,476 – 7,275
H	70,001 – 100,000	24	7,276 – 14,475
I - J	100,001 – 250,000	27	14,476 – 54,975
K	>250,000	28	54,976 and above