MALAYSIAN BUDGET 2006 SUMMARY

3 October 2005

On Friday, 30 September 2005, Malaysian Prime Minister and Finance Minister, Abdullah Ahmad Badawi, tabled his 2006 Budget in Parliament.

In his speech the Prime Minister moved the second reading of a Bill intituled "An Act to apply a sum from the Consolidated Fund for the service of the year 2006 and to appropriate that sum for the service of that year".

Despite slowing world growth and rising international oil prices, Prime Minister Abdullah's speech was generally upbeat with expectations of broad-based growth and solid macroeconomics in 2005/2006. His personal touch was evident in remarks on our maintenance culture and the deadly, dilapidated bridges used by schoolchildren, as well as exhortations to save energy by not air-conditioning our offices excessively.

In addition to "business-friendly" policies, the "soft infrastructure" of human capital development, and organizational and delivery systems, strong emphasis will be placed on developing the rural economy, and on physical infrastructure and educational facilities in less developed areas, to improve the general quality of life.

The following are some of the highlights and major proposals in the 2006 Budget Speech:

Budget Strategy

With the theme "Strengthening Resilience, Meeting Challenges", the 2006 Budget focuses on the following strategies:

"First: Implementing proactive Government measures to accelerate economic activities;

Second: Providing a business-friendly environment;

Third: Developing human capital; and

Fourth: Enhancing the well-being and quality of life of Malaysians"

To implement the above strategies the Government will appropriate RM136.8 billion (US$36.3 billion) to the 2006 Budget (13% higher than 2005) comprising Operating Expenditure of RM101.3 billion (US$26.9 billion) and Development Expenditure of RM35.5 billion (US$9.4 billion).

Operating Expenditure will be distributed as Fixed Charges and Grants, 54.3%; Emoluments, 23.3%; Services and Supplies, 20.3%; Purchases of Assets (e.g. office equipment and facilities) 1.6%; and other expenditures, 0.5%.

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

In 2006, the Federal Government deficit will be reduced from (an estimated) 3.8 percent of GDP in 2005, to 3.5 percent.

Economic Performance[1]

- In the first half of 2005, economic growth was sustained at 4.9 percent, mainly by private sector activity. GDP growth for the whole of 2005 is expected to be 5.0 percent (2004: 7.1%) and 5.5 percent in 2006. These expectations are based, among others, on the RM2.02 billion of Foreign Direct Investment in the first half of this year (2004 comparative: RM1.05 billion) and generally improved investor confidence driving private consumption

- The fiscal deficit is expected to reduce to 3.8 percent of GDP (2004: 4.5 percent). Monetary policy is expected to remain accommodative despite rising oil prices and widening interest-rate differentials

- Inflation in the first eight months of 2005 remained "manageable" with the CPI increasing 2.8 percent (2004 comparative: 1.2%). Unemployment is holding steady at 3.5

[1] To compile this summary, reference is also made to the Ministry of Finance's just-released Economic Report 2005/2006, as well as the periodic releases of the Economic Planning Unit, Department of Statistics and others

percent, the fourteenth consecutive year of effective full employment. Per capita income is expected to increase to RM17,741 (2004: RM16,616) and purchasing power parity, to US$10,323 (2004: US$9,360)

- The country's consecutive monthly trade surpluses continued unbroken since November 1997. As at 15 September, international reserves stood at RM304.36 billion (US$80.75 billion) (2004: US$54.45 billion) sufficient to finance 9 months of retained imports

- The favourable balance of payments with trading partners is expected to continue for a fifth consecutive year, due to the substantial surplus of RM124.07 million in the goods account (2004: RM104.47 million) more than offsetting the deficits in the services, income and current account transfer accounts

- The services sector—the largest sector of the economy, including, among others, transport, storage and communications, and representing 57.8 percent of GDP (2004: 57.4%)—is expected to grow 5.8 percent in 2005 (2004: 6.8 percent) driven mostly by domestic consumption

- The manufacturing sector, representing 31.5 percent of GDP (2004: 31.6%) is expected to grow 4.8 percent in 2005 (2004: 9.8%) strengthening in the second half of the year driven by increasing global electronics demand

- In the first seven months of 2005, our largest trading partners remained the United States (the trade surplus due mainly to E&E, textiles and apparel exports), followed by Singapore (the sharply wider surplus this year due mainly to E&E exports), Japan (the traditional trade deficit due mainly to imports of E&E, plant & machinery and parts, against exports of E&E goods, and optical and scientific instruments) and China (a trade deficit, this year)

- At the end of May 2005, there were 1.62 million registered foreign workers comprising approximately 15 percent of total employment in the country (2004 comparative: 1.3 million and 12.4%, respectively). Professionals and highly skilled workers (commonly referred to as "expatriates") accounted for approximately 2 percent of the foreign workforce, most of them emanating from India, Japan and China

Budget Proposals

Tax Reform

- Group tax relief, previously only available to limited sectors, is extended to all locally incorporated, tax-resident companies, with effect from the year of assessment 2006 (financial year ending in 2006). Fifty percent of the current-year tax losses of a company will be offset-able against the income of companies in the same group. Among others, claimant and surrendering company must have paid-up share capitals exceeding RM2.5 million, and mutual or common ownership of at least 70 percent. Group relief will not be available to companies enjoying tax incentives such as Pioneer Status, Investment Tax Allowance and Reinvestment Allowance

- To discourage the trafficking of loss making companies, with effect from year of assessment 2006 (financial year ending in 2006) the carry-forward of unutilized tax losses and capital allowances to offset future income will be disallowed if the shareholding of the relevant company does not remain "substantially the same". Shareholders are deemed to be substantially the same from one date to another if, on both dates, more than fifty per cent of the paid-up and nominal values of allotted ordinary shares are held by or on behalf of the same persons

- The minimum income tax estimate of a company submitted annually for provisional tax purposes and payable in monthly installments, is lowered with effect from the year of assessment 2006 (financial year ending in 2006) from 100 percent of the provisional tax payable in the preceding year, to 85 percent (subject to appeal if the company expects to be significantly less chargeable)

- Specific or targeted exemptions from income tax, real property gains tax and stamp duty, usually implemented by Ministerial Order, will no longer require the time-consuming process of gazette notification to take effect. However, this proposal, which takes effect on 1 October 2005, does not specify the alternative legal formula, if any

- Assessments of income tax, petroleum income tax and real property gains tax are statute-barred after six years, except in the case of fraud. With effect from the year of assessment 2006 (financial year ending in 2006) such assessments will be permitted in any year of assessment (and within six years after the expiration of that year) in which an assessment is determined by the Courts on appeal or review, or in which an assessment is raised pursuant to the withdrawal of an exemption, relief, remission or allowance

- A Tax Agent is a person with relevant academic qualifications and professional experience, and is vetted and licensed by the Minister of Finance. Separately, a company auditor licensed by the Minister of Finance is also permitted to practice as a tax agent. With effect from 1 January 2006, only the holder of a Tax Agent license will be permitted to hold him/herself out as a tax agent, tax consultant, tax adviser or other like description. Auditors licensed before 2006 will benefit from a savings provision, however it is not clear from the Finance Bill precisely how this will continue beyond the periodic renewals of their licenses

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 (Johore), Sabah and Sarawak are eligible for Pioneer Status, Investment Tax Allowance or Infrastructure Allowance. The cut-off date for applications for these tax incentives is extended from the end of 2005, to the end of 2010

- A Pioneer Status company whose pioneer period expires on or after 1 October 2005 is now permitted to carry forward losses and unabsorbed capital allowances for deduction from post-pioneer income. The relevant post-pioneer business must be a continuation of the promoted (Pioneer Status) activity or product

- Building owners are given Investment Tax Allowance equivalent to 60 percent of qualifying capital expenditure incurred on improving energy conservation, to be set off against 70 percent of their statutory business income. Applications must be received by the Malaysian Industrial Development Authority between 1 October 2005 and the end of 2010

- For technical, vocational and skills training, RM493 million is allocated to increase student enrollments from 72,000 this year, to 98,000 next. An amount of RM100 million is allocated to the Industrial Skills Enhancement Programme, to train 4,800 unemployed graduates. Nearly RM1.0 billion is set aside for programmes at the various Industrial Training Institutes and Advanced Technology Training Centres. A sum of RM63 million is allocated to 47 training centers, to roll out the current double-shift training programme to another 9,300 trainees. And RM175 million is allocated to the Workforce Technical Transformation Programme, to train 12,000 students

Capital Markets

- A company listed on Bursa Malaysia, mainly engaged in the holding of investments and deriving at least 80 percent of its gross income from passive sources (namely, dividends, rentals or interest) will receive business treatment for income tax purposes, effective from the year of assessment 2006 (financial year ending in 2006). Concomitant expenses will be fully deductible; but tax losses and unutilized capital allowances will not be capable of carry-forward to future years of assessment

- The targeted stamp duty and real property gains tax exemptions to encourage mergers and acquisitions in sectors like banking, insurance and stock broking, are extended to all companies listed on Bursa Malaysia, to encourage them "to enhance their quality to compete in the global market … expand their operations, increase liquidity, widen [their] equity base and achieve better economies of scale". To be eligible for the exemptions, relevant transactions must be part of exercises approved by the Securities Commission from 1 October 2005, to the end of 2007, and completed not later than 2008

- Section 132G of the Companies Act 1965 will be repealed to remove inflexible rules that have complicated mergers and acquisitions, and restructuring exercises since 1992. The mischief originally addressed by the section, namely, corporate asset shuffling and the injection of assets of dubious value into listed companies, is now considered to be adequately monitored by the securities and listing regulations

- Consultancy, legal and valuation fees incurred in the setup of a real estate investment trust (REIT) will be tax-deductible with effect from the year of assessment 2006 (financial year ending in 2006)

- Standardized accrual principles will be applied to the tax-deduction of discounts and premiums incurred by issuers of bonds, and the corresponding gains accruing to investors, effective from the year of assessment 2006 (financial year ending in 2006). No details on the new accruals regime are provided

Technology Sector

- MSC-type tax incentives will be extended to selected companies undertaking ICT- or multimedia-related activities outside the so-called cyber cities of Cyberjaya, Kuala Lumpur City Centre, Technology Park Malaysia, Bayan Lepas (Penang) and Kulim Hi-Tech Park (Kedah). Shared services and (presumably) outsourcing businesses will be especially encouraged. Income tax exemptions will extend to 50 percent of statutory income either by way of Pioneer Status (tax holiday) for 5 years, or utilization of Investment Tax Allowance equivalent to half of qualifying capital expenditure incurred over 5 years. Applications can be lodged with the Multimedia Development Corporation (MDC) from 1 October 2005

- To channel more capital into biotechnology, a new Malaysian Life Sciences Capital Fund will be set up to pool investments from institutions and Government-linked corporations (GLCs). The Government will make the initial contribution of RM100 million to the Fund, which will be managed by the Malaysian Technology Development Corporation

- An allocation of RM868 million is provided for an R&D Grant Scheme under the Ministry of Science, Technology and Innovation, focusing, among others, on biotechnology, advanced materials and manufacturing, nanotechnology and alternative energy sources

Small & Medium-scale Enterprises (SMEs)

- The development finance institutions, Bank Industri & Teknologi (Bank of Industry & Technology) and Bank Pembangunan & Infrastruktur Malaysia (Development & Infrastructure Bank of Malaysia) were rationalized this year, and a new SME Bank set up under the re-designated holding company known as Bank Pembangunan Malaysia Berhad. To finance this new group's lending activities, a sum of RM9 billion will be raised from the capital markets with a portion of these funds going to increase the SME Bank's paid-up capital to RM1 billion. The SME Bank, which will commence operations on 3 October 2005, will provide financial facilities and services, and establish a venture capital fund for SME business expansion

- Fifty percent of *ad valorem* stamp duty normally payable on relevant instruments will be remitted (waived) in respect of the first RM1.0 million of any loan taken by an SME, with effect from 1 October 2005. The operative definition of SME is not included in the Finance Bill

Import Duties

- Import duties payable on a list of 51 goods (e.g. refractory ceramic constructional goods, glass fibres, electro-mechanical domestic appliances with motors, etc) are reduced from 25-30 percent, to 20-25 percent; while duty of 10 percent is newly imposed on 3 imported products (i.e. categories of uncoated paper and paperboard) both with effect from 4.00 pm, 30 September 2005

Further Information

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