Accounting bodies have warned that the cut in corporate tax for SMCs (small and medium size companies) could pose a "dividend trap" for many such companies and their shareholders. **RONNIE LIM**, executive director of Deloitte KassimChan Tax Services Sdn Bhd, explains why.

FOR Assessment Year 2003, the corporate tax rate was reduced from 28% to 20% in Budget 2003 for SMCs (small and medium size companies) with a paid-up capital of under RM2.5mil.

Profits beyond this threshold continued to be taxed at 28%. This two-tier tax rate mirrors the system in several countries. The maximum tax saving for a SMC is RM8,000 per year, and the government has estimated the loss of revenue at RM270mil.

**THE AWESOME MEASURE**

The two-tier corporate tax rate necessitated a change to the legislation in respect of dividend franking. Here, the horror story begins for SMCs and their shareholders.

The proposed legislation to amend Section 108 Income Tax Act provides that where a resident company meets the aforementioned paid-up capital criterion, it is entitled to deduct 20% tax from dividends effective year of assessment 2003.

The shareholder receiving the dividend is taxable at 28% thereon, in the case of a non-SMC corporate shareholder, a non-resident person or an individual within that highest tax bracket.

All these persons will have to pay 8% additional tax on the dividend. Where a gross dividend of RM300,000 is received, they will incur an additional tax liability of RM24,000 (8% x RM300,000) thereon.

It is immaterial that the dividend may have been paid out of profits which were taxed or substantially taxed at 28%; the tax credit attaching to the dividend is still 20% of the gross amount thereof due to partial imputation.

As a direct result of partial imputation, the rate of tax on each ringgit of profit earned and distributed by SMCs by way of dividend may increase.

Under the full imputation system, where a shareholder who is an individual in the top tax band receives a dividend from a SMC, the tax chargeable on both the profit of the company and dividend is generally 28% of the gross dividend.

Under the partial imputation system, this rate increases depending on the profit and chargeable income of the SMC as follows: For profit and chargeable income of RM300,000, the tax rate is 35.1%; for RM500,000, tax rate is at 36.7% and for RM1,000,000, it is at 37.9%. (The tax rate comprises combined taxes as a percentage of gross dividend).

The tax rate further increases where an SMC holding company is interposed between the two persons referred to above. The combined taxes as a percentage of gross dividend increases to exceedingly high rates of 42.4%, 45.9% and 48.6% respectively.

The percentage spirals upwards should another SMC be introduced as an additional tier in a holding structure.

**EFFECTS**

In order to avoid the above effects of partial imputation, some dividend paying SMCs may increase their capital beyond RM2.5mil or move their residence outside Malaysia.

Others may be dissuaded from paying dividends. Some may seek other ways of rewarding their shareholders.

When SMCs pay dividends, their Section 108 credit will not be depleted to the same extent as before and they may therefore not have sufficient retained earnings to utilise the credit.

The excess credit, perhaps accumulated over several years when 28% tax was paid, may be forever lost.

Some companies receiving dividends will have to revise upwards their estimate of tax payable for year of assessment 2003 in view of the reduced tax credit.

The Inland Revenue Board, on its part, may raise additional revenue by tracking recipients of dividends from SMCs, like non-residents, and seek to collect 8% additional tax from them.

**CONCLUSION**

Revenue lost to the government as a result of the lower 20% corporate tax band, RM270mil, should be more than compensated by tax payable by shareholders on dividends from SMCs. This rationalisation has yet to be fully appreciated by the corporate world.