









# Special Tax Scheme for Malaysia's Social Enterprise: An Incentive for Public Good

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**Abstract.** Social enterprise operations are always associated with the dual mission, i.e. social mission and profit orientation. These two missions are embedded as a mechanism for combating social problems through innovative approach in the organization of social enterprises. Social enterprise operates in Malaysia through different form business entities, such as partnership, company, and limited liability partnership. Social entrepreneurs will have the capacity through these business enterprises to produce their own profit and profits without relying on the government. Although their primary purpose is to serve social needs, Malaysia's social enterprise denies the benefit of tax exemption as applied to charities. These are being also levied on other private business companies with high rate taxes. The goal of this paper is therefore to explore the possibility of implementing new tax treatment for social enterprise in Malaysia, in order to encourage their involvement in social mission. This paper adopted library research approach combining legal research methodology which mainly involves document analysis such as case law, legal provision and legal theories to see how they might be used to the subject matter.

**Keywords:** Social enterprise · Income Tax Act 1967 · Charitable organization · Public good theory

## 1 Introduction

The concept of social enterprise has been recognized in a global world as an alternative way of promoting social well-being amongst the community. The aim of business organizations has gone beyond their conventional motive to generate income from this revolutionary model but has been expanded to fight social problems and promote social well-being in the society. Not only is the idea of social entrepreneurship more than that of non-profit organization and can occur in various types of business organizations or models for income generation and community service (Light 2006). Social companies were suggested to have a double bottom line and mixed approach in daily operation in

order to balance economic purpose and social objective (Emerson and Twerskey 1996). Many states have given significant attention to the emergence of social enterprise to promote their activity and appreciate their dedication to promoting social growth. There are also many examples of states such as the United Kingdom, and the United States has adopted unique social enterprise business organizations. Not only that, a part of a particular social enterprise business entity, the respective governments also come with tax incentives as a mechanism for supporting the operation of their social enterprise. For example, in the United Kingdom Social Investment Tax Relief was introduced to encourage public participation as a mechanism for social development in Community Interest Company. This paper is organized as follows. Section 2 reviews the related literature review of related topic such as Malaysia Social Enterprise, Malaysia Income Tax Act 1967, theory of public good in taxation and a general debate on tax treatment for social enterprise. Section 3 discusses the possibility to apply public good theory into social enterprise in Malaysia and comes with interesting finding of the study. Finally, Sect. 4 concludes the paper with limitation of the study and some recommendation for further research.

## 2 Literature Review

### 2.1 Malaysia Social Enterprise

In general, the idea of social enterprise in Malaysia is still new to regulate and encourage social entrepreneurs, without formal legislation and a business organization. As a result, social entrepreneurs in Malaysia will operate across various organizations due to this lacuna (Ishak et al. 2015). Consequently, the concept of social enterprise in Malaysia was engaged with different school of thoughts namely as social innovation and social business approaches (Harun and Abd Ghadas et al. 2017).

*"The idea of social enterprise in Malaysia may be very new but we already have many social entrepreneurial tools. These people are special because they see opportunities rather than problems and use business fundamentals to create social modes" (MaGIC 2015).*

Realizing this situation, various research and programs were carried out to encourage the activity of social enterprise. For example, Social Enterprise Blueprint outlines was introduced to encourage this creative approach (Social & Blueprint 2015) and a new business entity known as Public Interest Corporation also been suggested as a specific business vehicle for social enterprise in Malaysia (Shahril Nizam et al. 2017). In 2019, the government of Malaysia launched Guidelines for Social Enterprise Accreditation to recognize and define the status, scope of social enterprise practice in Malaysia. By this new regulation, only company is regarded as a social enterprise through which it is capable of producing its own profits. Including 10% tax deduction for those who contribute to social enterprise and promote the organization in government database, several incentives have been presented (Budget 2020).

Sadly, given this initiative, one of the major issues that Malaysian social entrepreneur faces in this category is the tax current. The tax benefit provided by the government

extends only to those who do not donate to the organizations themselves as charity. It would enforce equal tax treatment on conventional business organizations acting as commercial business organizations themselves. It is because, in Malaysia Income Tax Act 1967, there is no provision allowing business organizations with a social mission to automatically enjoy tax exemption status except with special recognition from the Inland Revenue Board (Abdual Kadir et al. 2019). This has called for social entrepreneurs to be disappointed as they claim that the main goal of their activity is to support economic development and social well-being, it is expected that social enterprise in Malaysia is treated equally with other charitable organizations that enjoy tax exemption status.

## 2.2 Malaysia Income Tax Act 1967

Undisputable tax is essential revenue collected individually for the government as well as business organization. With this revenue government main earns enough income to grow the country and provide the people with good facilities. As a state of federalism, all financial matters are concerned by the federal government, in accordance with the Federal Constitution's Ninth Schedule. It requires tax provisions for both persons and corporate organizations working under their jurisdiction. Thus, Malaysia Parliament gazetted an Income Tax Act 1967 as the law to regulate all income earned and tax in Malaysia for that particular purpose. The Inland Revenue Board administers this Law. Among the functions of this organization are determining, receiving and implementing direct tax payments in Malaysia for all individuals.

Section 2 of the 1967 Income Tax Act describes "individual" to include companies, a group of persons and a single company. It can be inferred from the provisions of the Income Tax Act 1960 above that income tax is levied on all persons (individual, a group of persons, and companies) residing in Malaysia, or receiving any income in Malaysia. In addition, the 1967 Income Tax Act is also based on a territorial concept according to which any income accrued in or derived from Malaysia will be taxed in that particular year. The 1967 Income Tax Act further classifies income classes that are chargeable, among these are:

- a) any business income or profit, for the period in which business activities are carried out;
- b) any benefit from the employment; and
- c) any dividend, tax, or refund
- d) Rent, royalty or fees, pensions and earnings or benefits which do not come under any of the above.

Therefore, the composition of tax treatment for business entities in Malaysia is levied individually for unincorporated entities comprising Sole Proprietor and Partnership, and corporate entities such as Company and Limited Liability Partnership for the entity. Furthermore, Malaysia always provides a business-friendly environment for all entrepreneurs. This could include comprehensive legal framework, and competitive tax treatment for all Malaysian business entities. There are some tax advantages provided by the government for that particular reason to be deducted by all business organizations before exceeding their taxable income. Tax deduction on business expenses such

as entertainment expenses, leasing and maintenance costs of their properties, equipment as well as insurance, investment tax allowance and double deduction opportunities are amongst the benefits.

In addition, in acknowledging the willingness of business organizations to support social growth, there are many tax benefits available for them to reap through their donation and any plan for Corporate Social Responsibility (CSR).

Income Tax Act 1967 Section 34(6).

*“In ascertaining the adjusted income of a person from a business for the basis period for a year of assessment, deductions shall be made from the gross income from the business for that period in accordance with the following subsections (the person, business, period and gross income in question being referred to in those subsections as the relevant person, the business, the relevant period and the relevant gross income respectively).”*

This clause requires any corporate company to subtract from the gross sales in order to account for the charitable works that they have involved.

Income Tax Act 1967, Section 44(6).

*“Subject to Subsection (12), there shall be deducted pursuant to this subsection from the aggregate income of a person for the relevant year reduced by any deduction falling to be made for that year in accordance with Subsection (1) an amount equal to any gift of money made by him in the basis year for that year to the Government, a State Government, a local authority or an institution or organization approved for the purposes of this section by the Director General on the application of the institution or organization concerned: Provided that the amount to be deducted from the aggregate income of a company for the relevant year in respect of any gift of money made by that company to any institution or organization approved for the purposes of this section by the Director General shall not exceed five per cent of the aggregate income of the company in the relevant year.”*

This provision allows the deduction up to 7% for individuals, and 10% for companies from their aggregate income of relevant year, of any charitable donation to government, government, local authority or any recognizable institution or organization as identified in Section 44(7) of the Income Tax Act 196. However, such donations must be done voluntarily without any value of consideration in return. Part of this, pursuant to Section 44(11C) of the Income Tax Act 1967, the Government of Malaysia has implemented tax benefits in the form of exemptions for any contribution to social enterprises. The key goal of this new policy is to inspire and promote social enterprise donation as a tool to support the activity of social enterprises in Malaysia. Every individual who donates to social enterprise is entitled to deduct up to 7% of their aggregate income and deduct not more than 10% of the aggregate income for enterprises. Being different from the provisions before Section 44(11C) of the Income Tax Act 1967 is based on the authority of the Minister for any national interest project. Table 1 show the summary of tax treatment for business entities.

**Table 1.** Tax treatment for business entity

| Business entities                       | Tax   | Tax treatment for charity   |
|---|---|---|
| Sole Proprietor                         | Tax will be imposed on the founder (individual tax) | 100% deducted from adjusted income for any donation to recognized charitable organization<br>7% can be deducted from aggregate income for any charity donation  |
| Partnership                             | Tax will be imposed on each partner                 | 100% deducted from adjusted income for any donation to recognized charitable organization<br>7% can be deducted from aggregate income for any charity donation  |
| Company & Limited Liability Partnership | Up to 24% and Corporate Tax                         | 100% deducted from adjusted income for any donation to recognized charitable organization<br>10% can be deducted from aggregate income for any charity donation |

### 2.2.1 Tax Treatment for Charitable Organization

Not all charities in Malaysia usually enjoy tax-exemption status. Only those with that status can enjoy full tax exemption but subject to strict requirements. The company must apply to the Director General of the Board of Inland Revenue to be registered as a charitable organization with a tax exemption status. Only three types of institutions or organizations can apply, based on the application guidelines, which are Company Limited by Guarantee of the Companies Act 2016; Organisation, registered under the 1966 Society Act; Organization registered under Law 1955 on Trustee Incorporation. In addition, among the conditions, which are placed on the recognized organisations; 1) organizations must be founded continuously and not for profit-orientation purposes; 2) the contribution will extend to all Malaysians regardless of their races, beliefs and political understanding. The above requirements also been indorsed by court in *Syarikat Pendidikan Staffield Bhd vs Ketua Pengarah Hasil Dalam Negeri* The High Court of Kuala Lumpur ruled that:

*“An organization should be regarded as being non-profit where, by its constituent documents or by operation of law, it was prevented from distributing its profits or assets to owners, members or any other individual or group of individuals when it was operating and on winding up. It was clear that by the applicant’s constitution, the operating surplus could not by law be distributed or applied for the benefit of*

*individuals or commercial companies. The applicant's income and property were applied solely towards the promotion of the object of the company." (916 [2011] 5 CLJ).*

Nonetheless, for those missing charitable status are still subject to tax on any income not related to non-profit motives. That means this kind of organization needs to pay tax on any profits derived from their commercial activities such as entrance fees for non-members of the association, or any profit from their commercial activities. They may only fully tax exemption on any of their donation to or any charity events conducted by the organization. From the above discussion it can be pointed out that the Income Tax Act 1967 of Malaysia has differentiated tax treatment for corporate entities and charitable organizations. For business organisations, they only enjoy tax exemption under certain conditions and percentages as given by the ACT, while charities enjoy tax exemption status only, with approval from the Director of the General Inland Revenue Board. There is no room for tax treatment for hybrid businesses like social enterprises in which social goals and profit orientation are pursued.

### **2.3 Taxation Theory of Public Good**

A public good theory is initiated by Henry Hansman in 1981. This theory proposed a justification on tax exemption for charitable organizations (Hansman 1981). According to him, tax exemption is a way of government 's appreciation to charitable organizations due to their commitment to provide services that, have to be provided by the government. In a nutshell, charitable organizations create public benefits by delivering goods or services which are implicitly considered good for public particularly for needy. These might include providing free healthcare, education, food and shelter for homeless. Scholars who support this theory also agree that the main purpose of this theory is to understand supply and demand for activities related to social development (Benchman 1965). The public good theory of tax exemption was also been recognized by court. The Supreme Court of United States, in *Bob Jones University vs United State*, explains that:

*"charitable exemption is justified on the basis that the exempt entity confer a public benefit - a benefit which the society or the community may not itself choose or be able to provide or which supplement and advances the work of public institution already supported by tax revenue. History, buttresses logic make clear that, to warrant exemption under Section 501 (c) (3), an institution must fall within category specified in the section and must demonstrable serve and be in harmony with the public interest. The institution purpose must not be so at odds with the common community conscience as to undermine any public benefit that might otherwise be conferred" (157, 1983 U.S. LEXIS 36;51).*

Interestingly an application of the principle of public goods/community benefit is not, however, solely for non -profit organization (Hall and Colombo 1991). It has been shown that the concept could also be extended to any organization pursuing charitable activities in the community benefit. As in the case of *Commissioner of Taxation vs Word Investments Ltd* [2008] HCA 55 the Federal Court of Australia held that while the corporation was not a charitable organisation and engaged in commercial operations, but

its establishment aim was specifically for charitable purposes, and that was enough to mark the organization as a charitable entity. Thus, it may enjoy tax exemption status as a charitable organization. Thus, it can be said subsidy theory proposes that, tax exemption treatment for non-profit organizations is a government's rewards for them, as to appreciate their commitments to serve for community development.

## 2.4 Tax Treatment for Social Enterprise

As regards to social enterprise, the operation of social enterprises as a hybrid organization has emerged to the debate on tax treatment against them. Several scholars challenged on the ability of social enterprise to receive similar tax treatment as enjoyed by charitable organization due to the similar purpose of establishment (Mathher 2010). They recommend that, tax exemption status should not be strictly available for charitable organization but should be extended for profit charitable agency like social enterprise. It because, the government has to appreciate any efforts, commitment taken by any organizations to provide social good by giving them tax break. They further argue that theory is not exclusively applied for charitable organization per se, therefore, the government must take into consideration any effort for social goods from any organization by giving tax breaks (Malani and Posner 2007) Moreover, to be different with conventional business entities in which only contribute to the social good in their fortunate times, social enterprise is bounded to obey with the main objective of its establishment and comply with legal framework, in which both of these requirement demand social enterprise to pursue commit with social good all the times.

Social enterprise also adopts self-sustainability principle while actively involved in an open market competing with other commercial entities. Through commercial activities, social enterprise has capability to operate independently without highly depending from government funding and donation to operate. This function is different with a typical charitable organization which are only demand for donations and grant from government to maintain. Therefore, conferring tax exemption status for social enterprise would provide cost-efficient resource allocation (Surrey 1970). Tax incentives will implicitly promote the growth of for-profit charitable organisations. This trend would reduce government budget allocations from direct spending towards community growth. Such allocation could then be channelled to other areas demand such as growth and defence.

Disagree with the above argument, Mayer and Ghadal argue that, it is difficult to understand the definition of public benefit as it is engaged in by non-profit organizations (Mayer and Ghadal 2014). According to them, the concept of public benefit is too broad, whereby all entities and organization may simply say that they have sought the public benefit. For example, traditional companies might claim that they have had a positive effect on society by creating employment for the local community (Mayer and Ghadal 2014). They further claim that the definition of social enterprise itself is not suitable for tax exemption because such treatment might challenge its characteristic as a hybrid entity due to the competitiveness of commercial business activity. Furthermore, it is also common practice by all countries that non-profit or charitable organizations are subject to several strict requirements to ensure that they adhere to their establishment objectives. Thus, the principle of public good is ensured by strict criteria by the non-distribution of

income, whereby the promoters and donors to the organisation are mindful that any gain is not their own private property but is to the benefit of others. If this kind of organization can distribute profit, a concrete mechanism is needed to demonstrate that the intent for the public good is prioritized over private interests. Perhaps most significantly, the plan to offer tax benefits to charitable non-profit companies might establish a new form of tax evasion for the private sector that would threaten government revenue. Furthermore, it was also argued that, by granting social enterprise tax exemption status, it would encourage issues of governance whereby if the management fails to achieve social goals as planned. These risks, therefore, tarnish the support of the tax base for the charity in general, and this may also affect non-profit organizations (Mayer 2017). In discussing this issue Hitoshi Meyer suggests that there should be three elements of a tax scheme for social enterprise (Table 2).

**Table 2.** Elements of a tax schemes

| Elements   | Details  |
|------------|--|
| Investment | A tax scheme for the social enterprise would facilitate and attract investors to provide the social enterprise with capital funding                                    |
| Commitment | The system would also play a significant role in ensuring that social enterprises respect their dedication to social benefit continuously                              |
| Purpose    | Selection aim to enable other business organizations to choose to act as a social enterprise that has both profit-generating and seeking at least one social advantage |

### **3 Discussion and Finding: Tax Incentive for Social Enterprise Business Entities in Malaysia**

Notably Malaysia Income Tax Act 1967 has distinguished tax treatment for profit enterprises and charitable organisations. Not only that, Malaysia Income Tax Act 1967 also strictly prohibits charitable organizations from participating actively as business entities in commercial activities. Nevertheless, it could be identified through subsidy theory of tax exemption, there are several spaces to appreciate the commitment of the social enterprise through a special tax treatment. In Malaysia, social enterprises that enjoy tax benefits depending on the nature of their chosen organization. Moreover, they may also benefit from an existing tax treatment available to all business entities in general, and from any other incentives such as capital allowance, tax preference, and double deduction. In addition, for community and charitable activities, it is recommended for to the government allow full tax exemption on all charitable activities carried out by social enterprises, such as the tax treatment received by non-profit organizations – not 10% as enjoyed by traditional commercial entities. So then, Malaysia’s social enterprises will only be charged on their economic activities. Therefore, for that particular purpose, the Malaysia Income Tax Act 1967 needs an amendment to give that effect.



Despite this, social enterprises in Malaysia operating through business entities also rely on investors for sustainability and to expand their business. Social enterprises can increase their commitment to community development and problem-solving through strong equity. Not only that, through this approach social enterprises can also extend to compete with conventional business companies in various commercial activities. It may also be proposed that the principle of contribution in Section 44(11) of the Income Tax Act 1967 should also be extended to all associates, shareholders and investors who have contributed and spent their profit sharing or dividend for the benefit of the general public. This suggestion is in line with several scholars when they also felt that for potential investment social enterprises should be seen as commonly applied by traditional profit ventures (Porter and Kramer 1999).

*“If investor can find the same courage the early institutional backers of the venture capital industry found, we will see talented social entrepreneur build large, effective organization that move needle on the social issue and deliver acceptable financial return at the same time” (Cohen and Sahlman 2013).*

## 4 Conclusion

As a developing nation, Malaysia has an inclusive tax system which tracks all income derived and earned by itself. The Income Tax Act 1969 in Malaysia separated tax status for economic and social growth activities. Strict conditions to obtain the tax exemption status were also imposed on charitable organizations. The advent of social enterprise in between commercial and charitable purposes has sparked a debate among scholars on the best tax treatment this new business idea should be implemented. Social enterprise growth in Malaysia is yet a new step. This growth needs special policy attention in fostering high potential as a hybrid organization of business. Therefore, by public benefit philosophy, there would be scope for more tax benefits not only for the company itself but for others who have played significant role behind the project, such as donors, investors and shareholders. With the current situation, it's time to promote and encourage the growth of this new sector is right for the government. As mentioned early, this paper is attempt to search for possibility to introduce new tax scheme for social enterprise in Malaysia.

However, this research is only adopted qualitative approach through document analysis to reach for it's objective, there are several limitations such as most of the contents were retrieved through document analysis some crucial information was difficult to obtain especially from authorities, and some of legal databased are not updated. Therefore, its highly recommended for another methods of research such as in dept interview or quantitative approaches for a solid and new finding.

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