Achieving fiscal resilience in a balanced manner

Budget 2022

Budget 2022 treads a fine line in balancing the immediate need to revitalize the economy and spur recovery while ensuring fiscal resilience. It strives to ensure corporations continue to pay their fair share of taxes, boost revenues while ensuring they remain competitive, and that businesses can continue to thrive through their integral part in ensuring the livelihoods of the rakyat.

Paving the route to recovery

Financial support

Access to financing for survival is certainly at the forefront of many businesses’ minds, small and medium enterprises (SMEs) and large corporations alike.

With expectations of returning to growth targets of 5% to 6.5% by 2023, the Budget commits to ensuring business survival by making available financing amounting to RM40 billion under the Semula Naga Kembali Malaysia Programme (Sukuk), providing a boost to the country's recovery. This is providing equity funding of at least RM10 billion to viable public-listed companies. Such support for large corporations would have far-reaching effects across all stakeholders, from employees and suppliers to the investing public and financial institutions.

Tax incentives

Various tax incentives have already been introduced to provide economic stimulus packages to weather the impact of the pandemic, so it is no surprise that new incentives announced in Budget 2022 are far more targeted. The move is in line with a more comprehensive Digital Ecosystem Acceleration Scheme (DE- SAC) — which grants preferential tax rates of 10% to 100% on investment. The incentive is available to up to 100 companies that can be utilised against 100% of statutory income. This is particularly attractive for high technology companies as it appears to remove location-based restrictions that exist under the Multimedia Super Corridor (MSC) Incentive.

Broadening the tax base

Despite announcing the largest budget so far, the government is still committed to reducing the fiscal deficit to 8% GDP instead of announcing new taxes such as a capital gains tax or reintroducing the Goods and Services Tax (GST), the government has made several potential additional revenues by enhancing tax administration as well as a clever approach to collect additional taxes from taxpayers who continue to enjoy large profits.

Enhancing tax compliance

The Special Voluntary Disclosure Programme (SVDP) for indirect taxes is a good move to increase collections at a lower cost to the authorities. This can also be seen as an opportunity similar to the SVDP for direct taxes in 2019, which brought about an additional revenue of RM6 billion. The SVDP has a broad scope covering current cases, including GST, the Sales and Service Tax and duties. This move is extremely attractive, given that the 10% remission of penalties in phase 1 and 50% in phase 2, with the potential remission of taxes in certain cases. As with all voluntary disclosure programmes, the government is required to ensure that taxpayers are given the assurance that disclosures made in good faith would give them the certainty all businesses seek. On the other hand, there should be proactive efforts by the authorities to identify high-risk taxpayers and encourage them to come forward in order for the programme to be effective.

Foreign source income exemption

The concept of territorial taxation at the heart of the Malaysian income tax system, and Malaysia’s tax residents have long since been accustomed to the principle that only income derived from Malaysia should be taxed. As such, the proposed blanket removal of the foreign source income exemption (FSE) under Schedule E of the Income Tax Act has created concerns among corporate and individuals receiving income from outside Malaysia.

FSE was introduced to encourage remittance of income from overseas to Malaysia to be spent or invested here. With increased globalisation today, it is not uncommon for Malaysians, both corporates and individuals, to have investments overseas. Thus, it remains important for such returns to continue to flow back to Malaysia rather than being parked overseas. FSE also promotes Malaysia’s status as an ideal location to set up holding companies with proper substance, alongside Singapore, which also has an FSE regime and a wide treaty network that offers beneficial treaty rates for remittance of dividends, interest and royalties.

Background to the abolition of the FSE

The move by the government to abolish the FSE comes in the light of Malaysia being added to the EU’s grey list for having a harmful FSE regime. As a consequence, this list of non-cooperative jurisdictions is part of the EU’s efforts to dampen on tax avoidance and harmful tax practices. As a country on this list, Malaysia is considered a jurisdiction that has made commitments to comply with EU standards and is subject to monitoring on these commitments. Another notable location that has been placed on the grey list for its FSE is Hong Kong.

What is considered a harmful FSE

The Organisation for Economic Cooperation and Development (OECD) and, by extension, the European Union recognises that not all FSE regimes are harmful. In fact, in many instances, an FSE is required to avoid double taxation. Despite the level of global tax cooperation under the Common Reporting Standards (CRS) and global initiatives such as the Base Erosion and Profit-Shifting (BEPS) plan, double taxation remains a concern for many multinational enterprisers. For example, Malaysia’s lack of a comprehensive DTAA with the US renders taxpayers reluctant on domestic legislation to claim relief from double taxation.

A harmful FSE regime is one that not only prevents double taxation, but results in abuse that leads to double non-taxation. Foreign-sourced income, which comes under scrutiny, would include interest and royalties, in which there could be a lack of “business” activity or “substance” to generate such income in the recipient.

What needs to be done

Malaysia should comply with international standards of tax transparency, participate in fair tax competition and meet its commitments under the Inclusive Framework of the BEPS plan. The question remains, however, whether a blanket removal of the FSE — as suggested in the Budget speech and appendix — is a step or many steps, too far too fast on the commitment of a long-standing tax treaty by the rakyat and eventually the local economy.

It is absolutely clear that abolishing an FSE regime is a solution to Malaysia’s commitments, it is not the only solution. In fact, it is extremely rare for countries to tax all foreign source income. Many EU member states and developed nations (for example, the UK) do not tax dividend income if certain criteria (such as minimum participation in the foreign entity) are met. It is entirely feasible for Malaysia to retain an FSE regime, provided that certain safeguards and mitigating factors to prevent tax abuse are introduced. The focus on what is particularly harmful in an FSE that have:

An overly broad definition of income from foreign tax evasion, notably foreign passive income without any conditions or safeguards; and/or

A nexus definition that is not non-compliant with the definition of a permanent establishment in the OECD Model Tax Convention.

If Malaysia wants to exclude certain passive income from taxation, it will need to ensure that it:

Implements adequate substance requirements;

Has robust anti-abuse rules in place; and

Removes any administrative discretion in determining the income to be excluded from taxation.

Foreign-sourced royalty income

When the government considers the deri-

vation of royalty income — that is, develop-

ment, enhancement, protection, mainte-

nance and exploitation (DEPM) — are performed in Malaysia, the authorities have previously taken the position that the royalty is considered to be sourced and taxable in the recipient jurisdiction. Among other things, the authorities, by the authorities, it would be advisable to introduce clear substance requirements (for example, minimum head count or expenditure, certain activities performed) in the Income Tax Act for royalty income.

Foreign branch/permanent establishment profits

This is not considered a risk area as Malay-

sia applies a nexus definition that is comp-

lant with the definition of a permanent establishment under the OECD Model Tax Convention in its domestic legislation.

Foreign-sourced interest income

Generally, most countries tax foreign-sourced interest income upon remittance to the lender. Where there are withholding taxes paid in the borrower’s location, the lender may claim a bilateral tax treaty. On the other hand, interest may be payable subject to local legislation in the absence of a DTA against the taxes paid.

Foreign-sourced dividend income

A proposal that abolishes the exemption for foreign-sourced dividend income is one of the measures adopted by many developed countries and countries in the region that adopt a territorial basis of taxation. There is also a growing trend among Malaysian-based groups or investment vehicles that have significant operations overseas and regularly remit dividends back to their Malaysian shareholders.

Implications of a blanket abolition of the FSE

A blanket removal of an FSE regime would have adverse implications such as:

Discouraging remittance of earnings abroad, decreasing liquidity and reinvestment into the Malaysian economy;

Further reducing Malaysia’s appeal as a location to set up investment vehicles;

Subjecting foreign permanent establishments to tax in Malaysia when they remit funds back to their Malaysian head office. Where there is no DTA, the Malaysian taxpayer would be unable to claim full relief of foreign taxes paid; and

Uncertainty about the extent of relief available, including financing and other shareholder costs for shareholders receiving dividend income.

In these very challenging circums-

Treatments of foreign-sourced dividend income in other non-harmful FSE regimes in Asia-Pacific

<table>
<thead>
<tr>
<th>Taxation</th>
<th>Singapore</th>
<th>Thailand</th>
<th>Australia</th>
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<tr>
<td>Tax rate</td>
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Note: Thailand’s income tax rate for its permanent establishment regime, unrelated to its FSE.

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