BUDGET 2022

Achieving fiscal resilience in a balanced manner

TRUST IN Resilience

BY JAGDEV SINGH

Budget 2022 treads a fine line in balancing the immediate need to revitalise the economy and spur reform while ensuring fiscal resilience. It strives to ensure corporations contribute a fair share to government revenues while ensuring they remain competitive and that businesses can continue to thrive, given 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 2022, the Budget commits to ensuring business survival by making available financing amounting to RM40 billion under the Semarak Niaga Keluarga Malaysia Programme. Besides this, the government is providing equity funding of at least RM3 billion to viable public-listed companies. Such support for large institutions 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 via 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 to introduce a more comprehensive Digital Ecosystem Acceleration Scheme (DESAC) — which grants preferential tax rates of 0% to 10%, or investment tax allowance of up to 100% that can be utilised against 100% of statutory income — is extremely attractive for high-technology companies as it appears to remove location-based restrictions that exist under the Multimedia Super Corridor (MSC) incentive.

For the broader group, the government has extended the special reinvestment allowance for two years for existing companies, bringing the cumulative period to five years. This certainly gives companies the incentive to reinvest or increase capital expenditure, to drive domestic direct investment.

Broadening the tax base

Despite announcing the largest budget so far, the government is still committed to reducing the fiscal deficit to 6% of GDP. Instead of announcing new taxes such as a capital gains tax or reintroducing the Goods and Services Tax (GST), the government is relying on 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. For taxpayers, this should be seen as an opportunity similar to the SVDP for direct taxes in 2019, which brought about an additional revenue of RM8 billion. The SVDP has a broad scope covering all indirect taxes, including GST, the Sales and Service Tax and duties. The programme is extremely attractive, given the 100% 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, it is important for the government 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 is at the heart of the Malaysian income tax system, and Malaysian 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 (FSIE) under Schedule 6 of the Income Tax Act has created concerns among corporates and individuals receiving income from outside Malaysia.

FSIE 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. FSIE also promotes Malaysia as a potential location to set up holding companies with proper substance, alongside Singapore, which also has an FSIE regime and a wide treaty network that offers beneficial treaty rates for remittance of dividends, interest and royalties.

Background to the abolition of the FSIE

The move by the government to abolish the FSIE comes in the light of Malaysia being added to the EU's "grey list" for having a harmful FSIE regime. As context, this list of non-cooperative jurisdictions is part of the EU's efforts to clamp down 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 FSIE is Hong Kong.

What is considered a harmful FSIE

The Organisation for Economic Cooperation and Development (OECD) and, by extension, the EU recognise that not all FSIE regimes are harmful. In fact, in many instances, an FSIE is required to avoid double taxation. Despite the level of global tax cooperation under double treaty agreements (DTAs) and global initiatives such as the Base Erosion and Profit Shifting (BEPS) plan, double taxation remains a concern for many multinational enterprises. For example, Malaysia's lack of a comprehensive DTA with the US renders taxpayers reliant on domestic legislation to claim relief from double taxation.

A harmful FSIE 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 internationally recognised 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 FSIE — as suggested in the Budget speech and appendix — is a step, or many steps, too far to the detriment of all Malaysian taxpayers and eventually the local economy?

It is absolutely clear that although abolishing an FSIE regime is a solution that meets 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 FSIE regime, provided that certain safeguards and mitigating factors to prevent tax abuse are introduced. The focus on what is particularly harmful is on regimes that have:

- An overly broad definition of income excluded from taxation, notably foreign source passive income without any conditions or safeguards; and/or
- A nexus definition that is 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

Where key functions related to the derivation of royalty income — that is, development, enhancement, protection, maintenance and exploitation (DEMPE) — are performed in Malaysia, the authorities have previously taken the position that the royalty is considered to be sourced and taxable in the country. To cement the position taken by the authorities, it would be advisable to introduce clear substance requirements (for example, minimum headcount or expenditure, certain activities to be performed) in the Income Tax Act for royalty income.

Foreign branch/permanent establishment profits

This is not considered a risk area as Malaysia applies a nexus definition that is compliant 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 credit (or unilateral credit, where permissible under 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 quite contrary to regimes adopted by many developed countries and countries in the region that adopt a territorial basis of taxation. There is also a clear disadvantage to 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 FSIE regime

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

- Discouraging remittance of foreign-sourced dividends to Malaysia, thus reducing 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 circumstances, the finance minister certainly has a viable plan that will help address the more immediate needs of businesses while ensuring fiscal resilience. Various measures to promote business activity will certainly spur economic recovery. While businesses and the rakyat are comforted by the fact that there are no new taxes, some of the proposed measures may have far-reaching consequences, depending on how they are implemented. We need to ensure that, as a country, we not only remain competitive in terms of attracting investments but also encourage Malaysian businesses to compete on the global stage. E

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Treatment of foreign-sourced dividend income in other non-harmful FSIE regimes in Asia-Pacific

	SINGAPORE	THAILAND	AUSTRALIA
Taxable?	Yes	Yes	Yes
Exemptions available?	Yes	Yes	Yes
Key criteria for exemption	– Income is subject to tax in the foreign location (includes dividend taxes and income taxes on the income out of which the dividend is paid) – Foreign headline tax of at least 15% – Exemption is beneficial to the Singaporean resident tax payer (in the absence of the tax exemption, the resident taxpayer would be subject to a higher level of tax payable).	– Minimum participation of 25% – Minimum tax rate of 15% on the profit of the foreign company	– Minimum participation of 10%

Note: Thailand is on the EU's grey list for its preferential tax incentive regime, unrelated to its FSIE