Hasilian Research Snapshot

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MALAYSIA: RECONSIDERING TERRITORIAL TAX SYSTEM IN A GLOBALISED WORLD

Abstract

- The tax exemption of foreign income adopted in Malaysia since the mid-1990s was expected to spur repatriation of foreign income earned by Malaysian residents. However, since 2006**, Direct Investment Abroad (DIA)** of Malaysia has outpaced Foreign Direct Investment (FDI) inflows.
- This thesis extends the review of Malaysia's territorial tax system by examining the foreign income tax exemption policy from **costs** and **benefits perspectives** as well as its **risk exposure.**
- The main findings suggest that from the **cost perspective**, tax base forgone by Malaysia is **less significant** compared to a country adopts the worldwide taxation.
- From the **benefit perspective**, returns on DIA less than offset returns on FDI and the spill over effects of DIA were **insignificant** on domestic industries and domestic investments.
- Uncertainty on actual business activities through Investment Holding Companies (IHCs) and International Offshore Financial Centres (IOFCs) might undermine years of government's hard work in outward investment policy.
- Meantime, the exclusion of four specified industries i.e. banking, insurance, sea and air transport from enjoying foreign income tax exemption and diverse tax treatment of passive income particularly interest income might distort the incentive.
- This will cause taxpayers to alter their behaviour, and lead to tax avoidance.

Problem Statement

- Malaysia has successfully become an emerging source of DIA in the Asian region but has raised concerns as to whether the DIA would ultimately increase domestic investment.
- Minimal conversion into ringgit is observed from the repatriated income as it is generally kept in foreign currency to be re-channelled into new investments abroad.
- Globalisation is making it much easier for Multinational Enterprises (MNEs) to shift profits to low-tax jurisdictions. Modern technology has also made it simpler for wealthy individuals to move the capital to offshore financial accounts. Furthermore, taxpayers have the possibility to exploit the differences in tax levels as between countries and the tax advantages provided by various countries' taxation laws.
- To combat tax evasion and avoidance, Malaysia is committed to implementing Automatic Exchange of Information (AEOI) on financial account. Although Malaysia does not impose tax on foreign financial income, the offshore financial income information received is extremely useful as a database source to construct more comprehensive wealth data of taxpayers.
- Under current territorial tax system, Malaysian residents are not obliged to report their foreign financial assets nor foreign financial income to tax administration and this makes it harder for tax administration to identify the source of the offshore financial account.

Research Questions

- Is the current territorial tax system effectively preventing tax leakage in the nowadays globalised world?

Objectives

- To examine the tax policy in exempt tax on foreign income from the costs and benefits perspective in the case of Malaysia.

Framework

The Proposed Research Framework by the Researcher

Understand The Historical Background of Adopting Territorial Tax System

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Understand The Current Tax System in Malaysia

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The Analysis of Malaysia's DIA and Malaysia's Non-DIA

Methodology

- The thesis used secondary data i.e. balance of payments data and investment abroad data published by the Department of Statistics, Malaysia and Central Bank of Malaysia. These data were used:
  i. to test whether the tax exemption of foreign income will positively influence the DIA outflow and remittance inflow for domestic investment in Malaysia
  ii. to measure the relationship between the policy of exempting foreign income and DIA outflow to low-tax jurisdictions
  iii. to get some concrete or reasoned conclusions about what tax policy should be or what is really going on after the previous tax policy was implemented. What has been happening in the capital flow after providing an exemption of foreign income?

Findings

- Foreign corporate profits accrued by a subsidiary abroad is paid out as dividend income to its parent company.
- From the cost perspective, tax revenue forgone by the Malaysian government from foreign corporate profits is the additional tax imposed on the DIA's investment income paid out as dividend income. This may not be the same in the case of Malaysia adopted the imputation tax system on dividend income in the early days and replaced with the single-tier tax system in 2008 where corporate profits are taxed only one time. In addition, the same "taxed one-time" treatment is applied on dividend income paid to non-resident where withholding tax at 0% is applied.
- Thus, in Malaysia, the tax base forgone is smaller compared to a country adopts the worldwide taxation.
- On the other hand, from the benefit perspective, investment returns on Malaysia's DIA less than offset investment returns on Malaysia's FDI. In addition, the spill over effects of DIA on domestic industries and domestic investments were insignificant. Therefore, the benefit generated by DIA in increasing tax revenue is still unprovable.
- About 29% of DIA is now accumulated in IOFCs and about 27% of DIA is invested through IHCs. However, uncertainty on actual business activities carried in ultimate destination through IHCs and IOFCs might undermine years of government's hard work in cultivating outward investment policy.
- The tax exemption of foreign income is not applicable to banking, insurance, sea and air transport industries. Therefore, foreign income earned by these four excluded industries is taxed on worldwide basis. The concern raised here is whether this exclusion may cause tax distortion on these industries or induce these industries to engage in tax avoidance.
- Many countries still maintain their worldwide taxation on individuals and corporate's passive income. Individuals can't shift their active income from high-tax to low-tax jurisdictions without moving themselves physically. However, individuals can evade taxes on financial passive income, such as interest, by not reporting income earned abroad.
- Currently, Malaysian corporate domestic interest income is taxable but corporate foreign interest income is tax exempt; individual domestic interest income is taxable except for bank interest received from the Malaysian banks but foreign interest income is tax exempt.
- The diverse tax treatment of passive income might induce taxpayers to engage in tax avoidance.

Conclusion

- This thesis provide evidence that implementation of the exempt tax on foreign income is positively associated with DIA in the low-tax jurisdictions.
- The implementation of the exempt tax on foreign income is less effective in attracting repatriation of foreign income back to Malaysia.
- The thesis suggests two recommendations of tax policy to enhance the current Malaysian tax system:
  i. An anti-avoidance rule similar to CFC rules to prevent the erosion of the tax base when companies operate through foreign subsidiaries in tax havens
  ii. From tax planning perspective, a tax should be imposed on both domestics and foreign interest income, regardless of the corporations or individuals earned the interest income.

Research Gap

- It is critical to improve data collection to deepen the understanding of tax administration on the relationship between outward investments and tax exemption of foreign income in order to provide better research support for tax policy formulation in Malaysia. At presence, there is still no published data available with regard to DIA's ultimate destination, actual business activities invested through IHCs and repatriation of investment income. On the other hand, the data of outward portfolio investment and other investment are limited which only annual figures are made available without a detailed type's breakdown.
- It is hoped that in future, a detailed research is recommended to study why Malaysia should enhance its territorial tax system to minimise its risk exposure to tax avoidance and to examine capital mobility or to assess Malaysian residents' ability to escape the income tax by moving capital overseas without moving themselves. If the capital mobility is high, it might cost Malaysian government lost its revenue.