The Global Tax Reform and Its Implications on Malaysia

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POLICY BRIEF

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Acknowledgements

This policy brief is commissioned with the purpose of providing policy makers with insights on key development relating to BEPS and proposals from the G7 nations to reform international tax practices in the early June 2021. It our belief that the Malaysian government must pay close attention to these development in light of Malaysia's own considerations of its domestic tax reforms.

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Introduction

A key development emerging from the G7 Finance Ministers meeting which took place on 5th June 2021 was a communiqué centred on principal design elements for international tax reform for the Organisation for Economic Co-operation Development's (OECD) countries (Macdonald et al., 2021). The purpose of this move is to gain higher tax revenues by addressing the long-standing issue of multinational corporations (MNC) taking advantage of loopholes found in tax systems.

The communiqué proposes the introduction of two pillars to reshape the global tax system by addressing the digital economy and to ensure that companies pay taxes where they operate (Chan & McHugh, 2021).

The two pillars

Pillar One: Addressing the digital economy. Developments over the digital economy and tax regimes by individual countries towards digital companies have been much debated in recent times (Choo, 2020). At present, the Based Erosion and Profit Shifting (BEPS) framework by the OCED and G20 fail to address tax allocations among the resident country or the source country from which these tech companies are from. Here, Pillar One proposes that the larger, more profitable MNCs "...that generate revenue above a nominated profit threshold of 10% are expected to reallocate at least 20 percent of the profits to market jurisdictions where consumers are based" (Paddington, 2021). The proposal intends to close gaps in the international tax system that have allowed MNCs and tech giants in the likes of Facebook, Google, and Apple to "escape" tax payments due to the lack of a physical presence in countries they conduct business activities. These include online advertising and digital streaming services.

Pillar Two: Overcome tax-based erosion and profit shifting. The "race to the bottom" phenomenon took place in the 1980s with countries attempting to outdo each other by offering attractive corporate tax rates in an attempt to woo MNCs and their much desired FDIs. This resulted in average statutory rates declining from an estimated 50 percent to nearly 24 percent (Rodrik, 2021). A significant amount of MNCs shifted their profits to pure havens such as Bermuda, Cayman's Island, Bahamas, and the British Virgin Islands to enjoy low-to-zero tax rates (Economist, 2021). According to Macdonald, Gray, and Marley (2021), while the BEPS is centred on preventing "stateless income" over time, the framework does not account for MNCs shifting their business interest to investment zones and other low-taxed jurisdictions. This is why companies like Google and Facebook once had holding companies in Ireland (Kollee, 2020). Pillar Two's introduction of a global minimum corporate tax rate of at least 15 percent is intended to curb such issues arising from domestic tax-based erosion and profit shifting which will allow countries to apply a minimum rate on MNCs operating within their borders regardless if the company is headquartered in a low-tax jurisdiction (Macdonald et al., 2021). This prevents MNCs from offsetting taxes paid in one market against obligations in another (EIU, 2021). Hence, this pillar provides national governments with the ability to increase domestic corporate tax rates while at the same time minimise the risks of MNCs transferring their operations to low-tax jurisdictions.

The Biden administration estimates that around 100 MNCs will fall within the scope of Pillar One and conversely, according to Janet Yellen, Pillar Two was anticipated up to 8,000 MNCs would be required to pay a minimum corporate tax under Pillar Two (Partington, 2021).

The OECD projects that a significant USD81billion in additional tax revenues would be raised each year under the proposed reforms assuming a global minimum rate of 12.5 percent is applied under Pillar Two (Chowdhury & Jomo, 2021). Concurrently, if the global minimum rate is set at 21 percent, the initial rate proposed by the Biden administration, tax advocacy groups estimate that governments can raise USD$640 billion in underpaid taxes.

Rationale and objections

The rationale for enforcing tax harmonisation is strongest when countries share similar interests and seek to avoid the prisoner's dilemma where their primary motivation for lowering taxes to avoid capital outflows can be realised. However, when countries vary in levels of development and other characteristics such as their sources of income and political structure, what may seem appropriate in one context may be an obstacle to growth in another.

In effect, this tax proposal faces two contradicting objections. Tax-justice advocates argue that the global minimum of 15 percent is too low, while lower tax-rate countries would see it as an unjustified constraint that potentially restrict their capacity to attract investment (Ellyatt, 2021). Garnering support from countries which has consistently utilise tax incentives could be a challenge. Ireland, with a relatively low statutory rate of 12.5 percent, has signalled that a minimum 15 percent tax rate will disrupt its current economic model and cost them €2 billion or a reduction of approximately 2.4 percent per annum in government revenue (Economist, 2021). Similarly, havens like Paraguay, Hungary, and Cyprus which have used low corporate tax rates to lure investment would be particularly anxious with the possible loss of skilled labour and large capital outflows should this plan be implemented.

China has been giving tax breaks to promote its governmental objectives such as R&D to lure FDIs and would be reluctant to give up using such tax incentives due to “legitimate concerns” (Thomas, 2021). On the other hand, the Indonesian, South African, and Mexican finance ministers have shown support towards the deal as they would be able to gain additional tax revenues from MNCs (Nienaber, 2021). However, loopholes have been identified in Pillar One as it only applies to companies that exceed a 10 percent profit margin. With “clever accounting”, it is possible for a company with large profits to have low-profit margins. By definition, a company like Amazon does not fall under this scope as they only have a 6.3 percent profit margin (Jolly, 2021).

Critics of the G7's tax proposal come even from within, with French finance minister Bruno Le Maire saying that they "will fight to ensure that this minimum corporate tax rate is as high as possible" (Myer & Walt, 2021). José Antonio Ocampo, Professor at Columbia University stated that: "it would not be enough to end the race to the bottom" while economist Gabriel Zucman said that a 15 percent rate was too low (Keane, 2021). Instead, a 21 percent rate would be a fairer rate to prevent MNCs from moving their profits offshore to a low-tax jurisdiction, according to the IPPR (2021) think tank report.

Effect on developing countries

Developing countries may experience more significant effects from this tax reform as governments can rely more on corporate taxes (OECD, 2021). This is primarily due to their sizeable informal sectors that have posed difficulties in raising personal income tax.

Despite such possibilities, less developed countries would remain wary as this tax deal has been criticised for being too complicated, inflexible, and unfair (Economist, 2021b). As many developing countries are deemed as unfavourable investment environments due to the lack of infrastructure and skilled workers, lower tax rates have been used to compensate for the lack of appeal to attract MNCs. The implementation of a global tax floor could remove this advantage.

Development networks Oxfam and Eurodad argued that the proposal would only benefit developed countries while developing countries risk being "left with scraps" (O'Dennell, 201). It was also argued that 60 percent of revenues from this tax harmonisation exercise would return to the G7 countries, which only comprise a-tenth of the world's population (Meyer & Walt, 2021). According to the OECD, reallocating taxation rights on selected corporations may improve corporate tax revenues in underdeveloped nations by only 1 percent (Economist, 2021b).

Impact on Malaysia

Some of the effects of the tax reform on Malaysia can be foreseen. For example, Pillar One's requirement for countries to eliminate their Digital Service Tax (DST) will nullify Malaysia's DST revenues from subscription-based electronic media, mobile applications and software, online training, and internet-based telecommunication from Malaysian-based consumers. DSTs have raised RM428 million in tax revenues for Malaysian public coffers in 2020 from services like Netflix and Spotify (Taxamo, 2021).

Pillar Two's requirement for countries to set corporate tax rates to at least 15 percent could affect Malaysia's appeal in the eyes of the numerous MNCs that have set up operations in Malaysia due to the tax incentives given to them. The immediate fear is if MNCs will take flight for countries with lower tax options. However, Malaysia maintains its appeal for its relatively affordable skilled workers and multilingual speaking populations. There may yet be reasons for MNCs to remain rather than move to another country, especially if these tax rules also apply elsewhere. Yet, the same can be said of other countries that offer better infrastructure and skilled workers that could be seen as more attractive venues. Malaysia will need to up its level of competitiveness to remain an attractive destination.

Another issue concerns Malaysian MNCs, some of which are government-linked (GLC), that have subsidiaries in tax havens and have operations in other countries. Companies like Petronas, Fortune Global 500's 186th largest company (2020), fall under the scope of Pillar One. To note, more than 15 percent of the Malaysian government's revenue is contributed by Petronas, according to Fitch Ratings (2020). Proceeding with this tax harmonisation exercise could reduce the country's revenues significantly as a portion of total profits will be used to pay taxes in countries where such MNCs have a consumer base.

Government Linked Companies	Tax Haven Countries
Axiata Group Berhad	Singapore
Sime Darby Berhad	Singapore
Gamuda Berhad	British Virgin Island
Genting Berhad	Singapore, British Virgin Islands, China, Hong Kong

Examples of Malaysian Companies That Could be Affected by G7 Tax Reform (Normah & Salwa, 2015)

Yet, if imposing a tax floor can potentially reallocate a greater amount of fiscal revenue back to Malaysia from companies that previously paid lesser taxes under the present global regime, the G7 plan could make the forgoing of the DST and the loss of revenues from Malaysian MNCs overseas quite worthwhile.

There is a need to determine the above side effects as a whole as there are bound to be positive and negative repercussions. This is key as Malaysia's fiscal space has been overly stretched by the COVID-19 pandemic and the subsequent fallout on her economy.

Conclusion: The necessity of an international tax reform

Although many MNCs are expected to oppose this proposal, some companies such as Google and Facebook have shown support (Rappeport. 2021). Yet, the question remains if such reforms are necessary to begin with and if existing mechanisms can be used instead. Dani Rodrik, a Harvard professor argued that the present global regime allows individual countries the flexibility to design their own tax systems based on their needs and preferences, which is more robust and durable compared to the proposed tax deal (Rodrik, 2021).

Ultimately, if MNCs are willing to pay tax amounts that are satisfactory to countries they operate, such discussions would not even need to have taken place. However, the simple reality is that MNCs are rational entities attempting to maximise earnings for their shareholders and themselves by exploiting every possible loophole. Such “rational behaviour” can at times conflict with the will of sovereign governments merely wanting a fair share of MNC earnings for the development and administration of their countries and the people that live there.

The establishment of new tax rules on a global level is intended to mutually benefit all parties – the multiple countries involved, not just ones offering low tax rates, as well as the MNCs by meeting in the middle. Negotiations will be brought forward to the G20 in July 2021 before haggling among 135 member nations of the OECD/G20 Inclusive Framework on BEPS (Partington, 2021). Malaysia must carefully consider the implications such a reform before deciding on its adoption. There may be kinks to smoothen in the negotiations to come and countries like Malaysia must keep an eye on how these changes can affect its standing with these corporations (and the vast capital they hold in the country) while at the same time be a team player on the global stage.

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