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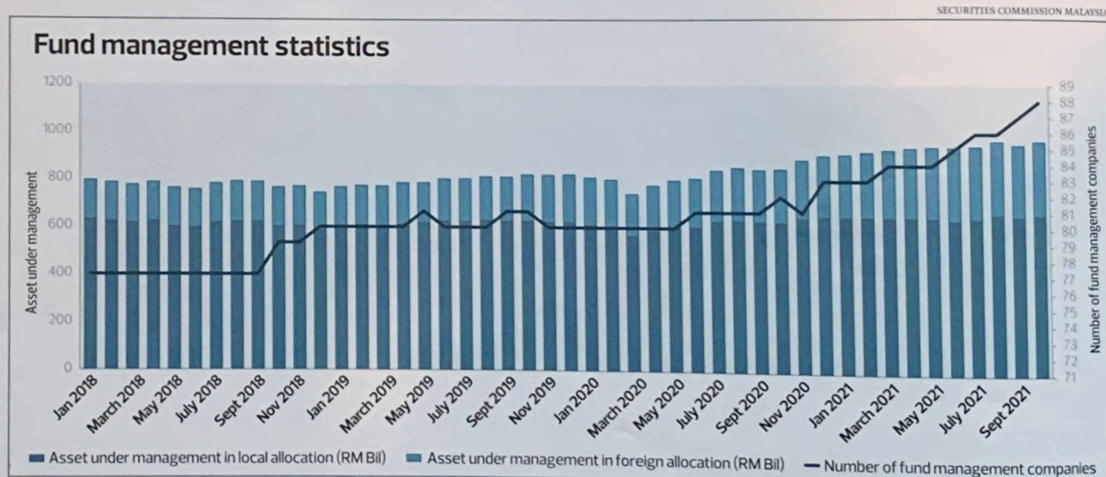
CAPITAL

Foreign funds to be hit by FSIE withdrawal?

BY KUEK SER KWANG ZHE



The announcement during the recent tabling of Budget 2022 that the tax exemption on foreign-sourced income (also referred to as foreign-sourced income exemption, or FSIE) would be withdrawn has created some confusion in the fund management industry.

Tax experts and private fund managers expect the performance of some regional and global funds to be impacted in various degrees. However, there are some exceptions, such as the Employees Provident Fund (EPF). Permodalan Nasional Bhd (PNB), meanwhile, has said it will not be affected.

EPF's foreign-sourced income still tax exempt

In response to a query from *The Edge*, EPF says its foreign-sourced income will continue to be tax exempt under Paragraph 20, Schedule 6 of the Income Tax Act 1967, which states that the income of any approved scheme is exempted from tax, and this would reasonably include its foreign-sourced income.

According to section 2 of the Income Tax Act, the definition of approved scheme means "the EPF, private retirement scheme or any pension or provident fund, scheme or society approved by the Director-General under section 150".

Tax consultant Yong Siew Chuen says these approved schemes include provident or pension funds set up by large corporations or organisations.

"Some big companies contribute an additional 4% to 5% to their own provident funds on top of the mandated 12% contribution to EPF. These funds aim to provide their employees with better benefits," she adds.

"Some of these funds are also approved schemes like EPF, in which case their foreign-sourced income would similarly continue to be exempted from tax."

Datuk Chua Tia Guan, executive director and head of tax and financial consulting at Asia Business Centre (ABC), a tax and financial consulting firm, shares Yong's view. "Paragraph 20, Schedule 6 of the Income Tax Act specifically states that the income of any approved scheme is exempted from tax. The word income would also include foreign-sourced income," he points out.

Chua says there is no public information available on which pension funds and schemes are approved schemes under the Income Tax Act, and one would need to approach the Inland Revenue Board (IRB) for more information.

Private investment funds to be affected

As for the various unit trust funds in the market, which are investment vehicles and not retirement funds, their foreign-sourced income will not be exempted from tax under Paragraph 20, Schedule 6 of the Income Tax Act, says Chua.

Pending further clarity, the consensus view is that private investment funds will be affected by the FSIE withdrawal.

"With the removal of the tax exemption on foreign-sourced income, investment funds such as unit trusts that generate returns in the form of dividends, interest or rental predominantly from foreign sources may be severely impacted, with such foreign-sourced income now being subject to income tax upon receipt in Malaysia," says Amarjeet Singh, EY Asean tax leader and tax managing director at Ernst & Young Tax Consultants Bhd.

"Depending on taxes incurred at source in the jurisdiction where the investment is located, there may be some tax credits available to reduce the tax to be paid in Malaysia

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Attractiveness of Malaysian investment funds could be impacted

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on such income, and investment funds would need to ensure they obtain and maintain sufficient documentation to support the foreign tax credit claims," he elaborates.

"Compared with corporates that may have more flexibility in considering options such as reinvesting overseas, Malaysian investment funds may still need to repatriate their income back to Malaysia to facilitate distribution to investors, who will now likely receive a lower return due to the taxes suffered at the investment fund level. Correspondingly, this can impact the attractiveness of Malaysian investment funds."

Bond funds that derive most of their income from foreign markets could see their performance (returns to investors) take a hit, says Lim Suet Ling, CEO of UOB Asset Management (Malaysia) Bhd.

Apex Investment Services Bhd CEO Clement Chew also expects equity funds that generate returns through dividend distributions from overseas companies to be affected.

However, most industry players are unsure how foreign-sourced income will be taxed in practice and how the tax relief, if any, can be claimed.

"We spoke to FIMM (the Federation of Investment Managers Malaysia) to clarify the tax treatment on money market funds last month, but we still don't know how it will be applied," says a local fund manager.

"This question of [tax treatment on] foreign funds [concerning FSIE] then came about. And it is also unclear. FIMM said it is talking to the SC (Securities Commission Malaysia) on the implementation. As details of the implementation are absent, industry players are drawing their own conclusions."

The government did not engage players in the asset management industry before announcing the FSIE withdrawal, says Lim. "From what we know, there was no prior engagement with the asset management industry to gather views and feedback on this matter. It would be helpful if asset managers are given more time to reposition their portfolios in anticipation of tax changes."

Tax matters can be complicated, especially when it involves funds that invest in overseas markets, says Chew. "For instance, a foreign fund can have 30 stocks in its portfolio. How will this be done if each stock distributes dividends, and we have to provide the IRB with all the necessary documents [to claim for double tax relief]?

"Assuming this is the case, we would need to set up a system to track these distributions. What if some of these stocks distribute dividends three to four times a year? It is a lot of administrative work."

Individual investors

The consensus among industry experts is that the man in the street, especially the middle income group, may feel the pain of the FSIE withdrawal.

Chew explains, "More people are increasingly diversifying into regional markets for better returns. They would not be able to reap the full benefit of doing so with the withdrawal of FSIE."

According to data provided by the SC, the assets under management (AUM) of the asset management industry hit RM970.01 billion at end October, of which RM307.9 billion was invested in foreign markets.

Of the RM307.9 billion, the asset allocation for foreign investments had grown 100.52% from RM153.55 billion at the start of 2018. For comparison, the total AUM only grew 30.45% during the corresponding period.

Says UOB's Lim, "It could negatively affect the net returns of trust funds with exposure to foreign investments, which are popular among local investors. It reduces the attractiveness of these funds, particularly those that derive a significant portion of returns from coupons [bond funds] and dividends [dividend-focused equity funds]."

"With the removal of the tax exemption on foreign-sourced income, investment funds such as unit trusts that generate returns in the form of dividends, interest or rental predominantly from foreign sources may be severely impacted, with such foreign-sourced income now being subject to income tax upon receipt in Malaysia." — Amarjeet

"In the long run, it may not bring us as much benefit as envisaged. I am still hopeful that the government will reconsider the FSIE withdrawal after hearing the feedback from industry players." — Chua

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From an income perspective, ABC's Chua says hundreds of thousands of people who travel to work in Singapore from Johor Baru (JB) and repatriate their foreign-sourced income onshore could see their wealth dwindle. Many of them are from the M40 (middle 40% income group).

Locals who work in Singapore, whose funds are deposited with the Central Provident Fund (the island republic's equivalent of EPF), will take a hit when they withdraw and repatriate their retirement money from the city state.

"EPF members can withdraw their money from EPF without being taxed. But for JB folks who work in Singapore, the money they withdraw from CPF will be taxed when repatriated to Malaysia," says Chua.

"They should be able to enjoy double tax relief in respect of tax paid in Singapore. However, due to the exchange rate difference and a higher individual tax rate in Malaysia, they may have additional tax to pay in Malaysia."

The full withdrawal of FSIE could hurt the M40 more than T20 (top 20% income group). The latter can afford to park their money overseas for their children's education or for travel, he says.

Double taxation relief

Perhaps some good news at the moment is that a chargeable person, which includes investment funds, is entitled to double tax relief with countries that have a double taxation agreement (DTA) with Malaysia. According to the IRB, Malaysia had effective DTAs with 74 countries as at June 21, 2019.

How does this work? Yong briefly explains the mechanism with a simple example. "Let's assume that a company generates rental income overseas, which is subject to a tax rate of 30%. When the income is repatriated to Malaysia, it is subject to another tax rate of 24%.

"Here is where the double tax relief comes into play. It is worked out by comparing the Malaysian tax rate with the foreign tax and is provided based on whichever rate is lower," she says.

"In the case above, assuming that the Malaysian company earned rental income of RM1 million, it pays RM300,000 in foreign tax (30%). When the income is repatriated to Malaysia, the company can claim double tax relief of RM240,000 (24%) against the IRB."

This could mean investment funds with foreign exposure will be less affected, but asset management firms would need to provide "a lot of documents" to the IRB for the tax relief, she adds.

Why not put some exemptions in place?

Yong says the government should have introduced certain exemptions instead of announcing a full withdrawal of FSIE.

In her view, active income such as income from business activities and salaries earned overseas should be exempted from tax. Dividends from foreign-sourced income should also be tax exempt to encourage Malaysian companies that invested abroad to repatriate their income.

Meanwhile, the tax exemption on other income such as royalties, including money paid by a third party to owners of products and patents, could be lifted.

"Sure, the government introduced such a measure to ensure that Malaysia complies with international standards to prevent double non-taxation, mainly on big companies and corporates that engineer their income not to be taxed globally. But it doesn't have to be a wholesale approach that discourages Corporate Malaysia and individuals from bringing their money home," says Yong.

"This is not uncharted territory. It is something that has been done and observed in the past. The government doesn't need to look far but at Singapore to learn from its experience. They should have put in specific exemptions to assuage uncertainties."

While the government estimates that it could raise RM1.2 billion from the FSIE withdrawal, it could affect the long-term competitiveness of the country as a location for regional investment, says Chua.

"In the long run, it may not bring us as much benefit as envisaged. I am still hopeful that the government will reconsider the FSIE withdrawal after hearing the feedback from industry players," he adds. ■