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## EY Tax Alert (Special Edition)

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### Coverage of this Alert

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# Malaysia added to the European Union's tax "grey list"

On 5 October 2021, the Council of the European Union (the Council) updated the European Union (EU) list of non-cooperative jurisdictions for tax purposes (the EU List). Malaysia was added to Annex II of the EU List, which reflects the status of commitments made by cooperative jurisdictions to implement certain tax governance principles.

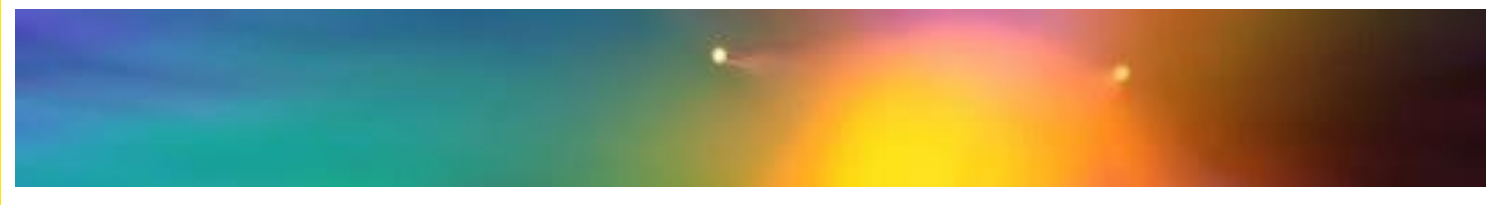
The Council will continue to periodically review and update the EU List, taking into consideration the evolving deadlines for jurisdictions to deliver on their commitments and the evolution of the listing criteria that the EU uses to establish the EU List. The next revision to the EU List is expected in February 2022.

Further information is set out below.

### Background

The EU started working on its list of non-cooperative jurisdictions for tax purposes in 2016 and published the first EU List on 5 December 2017. Broadly, the EU List is a tool to:

- ▶ Tax avoidance: address use of legal means to minimize tax liability
- ▶ Tax fraud or evasion: tackle illegal non-payment or underpayment of tax
- ▶ Money laundering: tackle concealment of origins of illegally obtained money



The EU List comprises two annexes, as follows:

▶ **Annex I (the so-called “black” list)**

Jurisdictions that failed to implement the tax reforms they had committed to, by the agreed deadline. The countries on the 5 October 2021 version of this list are American Samoa, Fiji, Guam, Palau, Panama, Samoa, Trinidad and Tobago, the US Virgin Islands and Vanuatu.

▶ **Annex II (the so-called “grey” list)**

Jurisdictions that have not yet complied with all international tax standards, but have made sufficient commitments to reform their tax policies. These jurisdictions remain subject to monitoring while they work on their commitments. Once a jurisdiction has executed all its commitments, it will be removed from Annex II.

The “grey list” also sets out the specific area(s) of the relevant tax regimes requiring reform, and the deadline for such reforms to be made.

*Foreign sourced income exemption regimes*

In October 2019, the EU, via its Code of Conduct Group (COCG) published “Guidance on foreign sourced income exemption regimes” (Guidance). On 25 November 2019, the Council published a report from the COCG, which includes a list of new preferential regimes that the COCG had identified for review. The list included foreign source income exemption (FSIE) regimes, that would be reviewed in 2020. The report was endorsed during the EU Economic and Financial Affairs Council meeting on 5 December 2019.

The Guidance acknowledges that FSIE regimes, or regimes that charge corporate tax on a territorial basis are not in themselves problematic. However, problems arise when such regimes not only prevent double taxation, but also create situations of double non-taxation. Specifically, the EU is concerned about FSIE regimes that:

- ▶ exclude foreign source passive income (e.g. dividends, interest and royalties) from taxation without any conditions or safeguards, as this can result in ring-fencing and a lack of economic substance;
- ▶ exclude foreign source active income from taxation that do not align with the international tax principles.

While the Guidance permits jurisdictions with FSIE regimes that are considered harmful to continue excluding certain types of passive income from taxation, they need to impose one or more of the following measures:

- i) implement adequate substance requirements for the entities concerned, in line with EU standards;
- ii) have robust anti-abuse rules in place;
- iii) remove any administrative discretion in determining the income to be excluded from taxation.

## Malaysia's commitment under the state of play document and implications of being on the list (Annex II)

Following the above, on 5 October 2021, the Council decided to add Malaysia to Annex II of the EU List. This is the first time that Malaysia was included on the list. Malaysia was included as it was identified as having a 'harmful' FSIE regime, but has committed to amend or abolish this regime by making the necessary legislative changes to remove or amend the harmful features by 31 December 2022. Other countries listed alongside Malaysia and which will similarly need to review their FSIE regimes are Costa Rica, Hong Kong, Qatar and Uruguay. Various other countries are also listed in Annex II, for other reasons.

Malaysia will not be subject to any so called "defensive measures" by being on the grey list. Defensive measures are reserved for blacklisted countries which are listed on Annex I. The four defensive measures include denials of deductions or higher withholding taxes on payments by EU Member States to blacklisted countries.

### Observations

The Malaysian Government has not yet issued any public guidance or feedback on this very recent development. It appears that to comply with Malaysia's commitments to the Council, the Government will need to revisit and update the foreign-sourced income exemption under Paragraph 28 of Schedule 6 of the Income Tax Act 1967.

Any amendment to the foreign-source income exemption would be a fundamental change to the Malaysian tax system. Before any changes are made to the tax system:

- i) The Government should undertake a public consultation process to ensure that the views of all relevant stakeholders are taken into account.
- ii) Malaysia must monitor how Costa Rica, Hong Kong, Qatar and Uruguay respond to their commitments to the EU. We should then consider whether some of the actions taken by these countries are relevant to Malaysia.
- iii) Malaysia should study countries which have a similar tax system, but which have not been placed on the EU's grey list, to see what we can learn. Singapore is one example.
- iv) Malaysia should holistically review its tax system and consider other developments which need to be addressed. For example, the OECD's Base Erosion and Profit Shifting (BEPS) 2.0 project<sup>1</sup> will also result in changes to Malaysian tax law, and such changes may need to be effective as early as 2023. Both the EU and OECD requirements should be addressed together, so that Malaysia does not have multiple significant changes to its tax regime. Investors value certainty and stability, and would be concerned with frequent changes to the tax regime.

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<sup>1</sup> The BEPS 2.0 initiative is made up of two "Pillars". Pillar 1 proposes to reallocate a certain amount of taxing rights of large multinational businesses to the "market economies", i.e. the jurisdictions in which customers are located. This is a significant deviation from current direct tax rules, which generally only allow business profits of a multinational enterprise to be taxed in the countries where it has a fixed business presence. Pillar 2 of BEPS 2.0 proposes a global minimum tax rate (currently expected to be 15%), which will be particularly relevant to countries with low tax rates and those which offer tax incentives.

Any changes made to our tax system must be in line with the overall economic and financial goals of the country. In a time that countries are competing strongly for foreign investments and evaluating appropriate holding company locations, it is imperative that the Malaysian tax system remains simple, easy to comply with and above all, competitive. We have until 31 December 2022 to make legislative changes - we must use this time to carefully study the position and not rush into any measures. Where possible, proper grandfathering and sufficient transitional periods should be allowed, before the new tax laws are implemented. In the meantime, to provide comfort to taxpayers, the Government should release a statement on Malaysia's placement on the EU grey list and the intended next steps.

Taxpayers should carefully monitor developments in this space and consider the potential impact to their tax positions and businesses.

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