Taxation of Foreign Investments in Malawi. Lessons from Japan

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Abstract

Foreign investments remain an important source of economic growth in both developing and developed countries. Their contribution to capital formation, employment opportunities, revenues and technology to the host countries are likely to continue creating strong competition among countries in attracting them. In order to be competitive, developing countries provide generous tax incentives to MNEs which tend to encourage high incidence of tax avoidance and evasion. With inadequate institutional capacity to ensure tax compliance, governments are losing more tax revenues from the MNEs who use complex accounting mechanisms to avoid tax payments. This paper has explained how Malawi Government has been taxing foreign investments to achieve optimal balance of increasing domestic resource mobilization and considerably attract new foreign investments. The central objective of the paper was to investigate taxation of the foreign investments in Malawi. The study primarily focused on Malawi tax system in comparison with international taxation from Japanese tax system. Furthermore, the paper investigated tax anti-avoidance measures that are available in domestic legislations which ensure tax compliance from the MNEs. The paper also discussed tax erosion practices that are associated with MNEs such as transfer pricing, internal debt arrangements among others that help to reduce taxable income of the MNEs. The paper has provided the shortfalls of Malawi international taxation system and some practical solutions have been recommended emanating from Japanese tax system.

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Abbreviations and Acronyms

ALP	Arm’s Length Principle
APA	Advanced Pricing Arrangement
CFC	Controlled Foreign Corporation
CUP	Comparable Uncontrolled Price
EPZ	Export Processing Zone
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
KStG	Körperschaftsteuergesetz (German Corporation Tax Law)
MNEs	Multinational Enterprises
NEPAD	The New Partnership for Africa’s Development
OECD	Organization for Economic Co-operation and Development
SARS	South African Revenue Services
TNMM	Transactional Net Margin Method
TWNA	Third World Network Africa
UNCTAD	United Nations Conference on Trade and Development
UN	United Nations
USA	United States of America
VAT	Value Added Tax

Chapter One

1.0 Introduction

Taxation is an integral and stable source of revenue for countries in financing their economic agenda. It forms an important part if well coordinated with other economic and development policies to shape the environment for investment and international trade in order to achieve high economic growth of a country. Taxation provides a predictable and stable flow of revenue to finance physical infrastructures and social programmes which are pillars of attracting Foreign Direct Investment (FDI). It is a known fact that investors are attracted to the countries with good economic growth and development performance. Michalet (2000) supported this point and included a number of conditions notably political stability, institutional flexibility, transparency and non-discriminatory legal and regulatory environment as also critical determinants of attracting Multinational Enterprises (MNEs). In addition to the non-tax determinants, empirical and theoretical results have also supported the fact that taxation plays a significant role in attracting foreign investments.

As a result of the factors above together with rapid change in technology and trade liberalization the world has seen an unprecedented growth of MNEs in the last four decades. According to UNCTAD (2009) statistics, the world inward stock of FDI increased to \$14.91 trillion in 2008 from \$1.94 trillion in 1990. Correspondingly, the world figures of outward stock of FDI increased from \$1.7 trillion in 1990 to \$16.21 trillion in 2008.

Nevertheless, these factors have also diversified geographical growth pattern of MNEs with developed countries having a large share of the inflow and outflow compared to developing countries. From the UNCTAD statistics, developed countries are ranked highly by having an inward stock of 68.5% of the world FDI compared to 31.5% of developing countries in the period between 1990 and 2008. At the same time, developed countries had a share of 84% outward stock of FDI while developing countries contributed 16% of the outward stock of FDIs.

Despite the 2008 financial crisis, MNEs continued to grow in developing countries vis-à-vis developed countries. African countries' inflow rose by $88 billion in 2008 from 2007 stock with main recipients being natural resource rich countries. Southern African countries received 31% and their inflow rose to $27 billion in 2008 from $19 billion in 2007, while overall inward stock increased to $166.4 billion in 2008 from $117.2 billion in 1990. As part of Southern African countries, Malawi's share of FDI inflow increased from $228 million up to $ 628 million and outflow increased to $21 million in the same period.

However, despite the increasing share of inward FDI and higher economic growth rate, developing countries' tax revenues have been decreasing as a percentage of GDP from 2.9% in 1992 to 2.3% in 2001. The revenues are not enough to finance much needed social and physical infrastructures and to reduce developing countries' dependence on foreign aid; yet developed countries were able to increase their tax revenues as a percentage of GDP from 1.9% to 2.5% in the same period, Goodspeed (2006). The reduction of revenue in developing countries is attributable to excessive tax subsidies or concessions as well as tax avoidance and tax evasion practices by MNEs. As a result of these practices, developing countries have failed to finance their social and physical infrastructures which are ideal to fasten economic growth and development.

Almost all governments in developing countries are competing to attract FDI by providing tax incentives that are believed to encourage higher FDI inflows. In the African context, most countries are facing challenges of finding optimal balance between taxation regime that can be business and investment friendly, while at the same time collect enough revenues to provide necessary services that would make their economies attractive to FDI. According to NEPAD-OECD (2009) report, African countries have lost an estimated 7.6% of the continent's annual Gross Domestic Product (GDP) in cash from 1991 to 2004 which in effect make African countries net creditors of donor countries.

Malawi is not an exception to the taxation challenges that most countries are facing. The country has for decades foregone millions of dollars in tax revenue because of its generosity in tax subsidies, or concessions, inadequate institutional capacity that can ensure tax compliance as well as tax avoidance and evasion practices by MNEs. With the largest mining company investing in Malawi in 2006, it is estimated that the country will forgo more than $124.5 million in revenues over the life-time of the project from the reduced income tax rate and royalty rate among other tax treatments.

Now the central argument remains to tax policymakers in developing countries to design appropriate tax regime that would optimize tax revenues to provide enough funds for financing their development priorities and also attracting investments.

1.1 **Problem Statement**

There has been a tremendous increase of FDI stock in Malawi since early 1970's and reached its record high in 2008 of U$627 million. Almost all the FDIs in Malawi are export-oriented as opposed to domestic market-oriented. The largest stock has been observed in the manufacturing sector compared to the distribution and financial sectors. In 2006, Malawi registered a major mining investment from Australia, Paladin (Africa) Limited. It is the first ever high capital-intensive investment as most of the manufacturing investments were labour-intensive vis-à-vis technology-intensive and capital-intensive.

Although empirical and theoretical evidence show that FDIs contribute to economic growth through capital formation, technology, revenues, advanced management skills, increased trade and other positive spillovers with domestic enterprises, Malawi has lost much revenue. The revenue loss is attributed either to poor design of tax policies or tax avoidance and evasion techniques by the MNEs. The country has widely used incentives such as tax holidays, export zones and secret contracts to compete with other countries to attract investment. These tax incentives, together with incidences of tax avoidance and evasion techniques by MNEs, have left Malawi Government Treasury without enough finances that could otherwise have been used to fund social and physical infrastructures necessary to facilitate economic growth and development.

These poor tax policies interwoven with inadequate capacity of tax administrators have led to country-wide concern, both from public and civil societies about the future of tax policies which are not in tandem with the integration of national economies in the world.

Against this background, there is need for a country to design tax policies that will strike the balance between collecting revenues necessary for public spending and at the same time investment friendly as well as transparent to be monitored through budget process by all residents.

1.2 Rationale of the study

MNEs will continue to grow because of rapid technological change, trade liberalization, privatization and geological resources. Many countries regard these MNEs as a source of economic growth and development. MNEs contribute to capital formation, create employment and provide physical infrastructures such as schools and hospitals, technical know-how and management skills. Above all MNEs provide governments with revenue either directly or indirectly. These factors have led to strong competition among countries both developed and developing to attract these investments into their jurisdictions.

Developing as well as developed countries are using incentives to attract FDI but they differ very much as developed countries use reduced local taxes and subsidized loans plus better market and infrastructures that leave developing countries with no option but resorting to the use of tax holidays or exemption. Developed countries are also reshaping their tax systems to attract more MNEs and also realize more revenues to sustain their growth and development policies while developing countries are distorting their tax systems and losing revenues. Usually most developed countries use world-wide taxation system and have double tax treaties between them to relieve double taxation on foreign earned income. On the contrary, most developing countries use territorial taxation system where income earned outside their borders is not taxed as it is deemed to be taxed where it is generated.

Malawi being a developing country taxes income based on territorial taxation system. The tax system does not reflect the growth in international business and also provides discretionary powers to individuals to provide incentives to investors. It is this background of lack of proper tax regime for international companies and also inadequate institutional capacity that has influenced this study. The lessons that will be learnt from this study will be instrumental to tax policy makers to formulate tax policies that are transparent and follow fundamental principles of international taxation policy. It is believed that Malawi can formulate appropriate tax laws that can attract MNEs but also that will benefit the country through increased revenues, capital formation, technology, advanced skills and employment opportunities.

1.3 Objective of the Study

The underline objective of the study was to analyze the taxation of foreign investments in Malawi and attempt to harmonize the tax regime to international taxation principles.

Specifically, the study evaluated Malawian tax system based on Japanese tax system on taxing international companies. The study also drew some lessons from Japanese tax system in order to align Malawi tax system to international tax principles.

1.4 Methodology

The study used comprehensive review of literature on international taxation of foreign investment. The study focused much on the tax systems of Malawi and Japan as well as some information on international taxation from OECD rules. These analyses intended to achieve the objective of understanding international taxation of foreign investment.

1.5 Organization of the study

The rest of the paper is organized as follows: Chapter two provides literature review on international taxation in both developed and developing countries. Chapters three and four outline taxation of foreign investments in Malawi and Japan. The last chapter will provide conclusion and policy recommendations.

Chapter Two

2.0 Literature on the Taxation of Foreign Direct Investments

2.1 Background on the growth of Multinational Enterprises

Taxation of foreign investment requires a deeper understanding of the activities of MNEs, their growth pattern and interest in the host country among others. MNEs being entities that conduct business in more than one jurisdiction, whether as a single taxpayer or group of entities, provide complex taxation issues for both tax administrators and MNEs themselves. Going by their definition, MNEs' activities in the world trade has increased significantly for the past two decades. For example, today the world has 82,000 MNEs with 810,000 foreign affiliates and they are estimated to account for about a third of total world exports of goods and services with 77 million employees among themselves, UNCTAD (2009). The increased role and growth of MNEs is attributed to rapid technological change particularly in the area of communication, advanced management skills within the firm, trade and investment liberalization, privatization, deregulation and political stability.

In addition to the factors above, Ietto-Gillies (2005), also mentioned that economic structure and natural resources have facilitated the growth of FDIs. These two factors have made developing countries to be greater recipients of the FDIs particularly labour-intensive MNEs with little in the services sector, whereas developed economies are greater recipients of technology-intensive and services sector MNEs. Goodspeed (2006) supported this observation and reported greater disparity in growth of financial services among developed and developing countries between 1988 and 1999. Goodspeed further observed that during same period, financial services grew by 13.3% compared to 12.2% in manufacturing sector with developed countries receiving greater percentage than developing countries. Goodspeed (2006), further indicated that even within the developing countries FDI differ significantly from country to country or within regions with some benefiting greater in the service and high-technology than manufacturing sector. The disparity is further deepened depending on whether MNEs are either export-oriented or domestic market-oriented, Tseng and Zebregs (2003). Hence, economic structure and natural resources have led to geographical diversification of MNEs with developing countries characterized by greater FDI inflows than outflows, while developed economies' inflows and outflows tend to be closer, with FDI outflow stocks often greater than inflow stocks.

Equally important to recognize is well established evidence from theoretical and empirical analysis that taxes play an important role in determining the location of production facilities by MNEs. As multinationals always try to minimize their tax burden either of the whole group company or subsidiary, they choose to locate production facilities depending on differences in international taxation. These tax differentials lead to flow of foreign investment into countries with low-tax rate than high tax rate. Fernandez and Pope (2002) provided Ireland as a particular example where foreign investment has grown tremendously because of low tax rates compared to other developed countries.

These changes in growth pattern of FDIs such as increased growth in the services sector, increased flow into emerging markets and trade activities among others have caused greater challenges on taxation not only to tax administrators but indeed to MNEs themselves.

Fernandez and Pope (2002) said that the fundamental problem relating to taxation of MNEs is that taxpayers have become global whereas tax authorities have remained national and operate with other jurisdiction through bilateral treaties. In this case, MNEs face different tax laws and administrative requirements which might be complex resulting to higher compliance costs and tax avoidance.

Having these insights of growth pattern of multinational enterprises, the next section will provide literature on taxation of MNEs arising from this growth pattern.

2.2 International Taxation of Multinational Enterprises

The most important point to realize when thinking about taxation of foreign investments is the tax system which a country uses in taxing corporations. There are two broad genres of taxation, which are source-based (territorial) tax system and residence-based (worldwide) tax system. Under territorial tax system which is similar to definition of Gross Domestic Product (GDP), countries impose taxes on all income that arise within their borders irrespective of residence of the taxpayers. In contrast, under a worldwide tax system, which is synonymous to Gross National Product (GNP) definition, countries include in their tax base all income that a resident generates within or outside their jurisdiction.

In practice, countries that use worldwide tax system such as USA, Japan, Italy, Belgium, and South Africa among others use foreign tax credit system in order to relieve corporations from double taxation on the foreign earned income. For example, USA Revenue Act under Sub-Part F provides relief to USA foreign corporations to credit their foreign taxes on foreign earned repatriated income into the USA. Wijeweera et al (2007), illustrated this point by showing that if the host country of USA corporation or subsidiary has high tax rate than 35% corporate tax rate in USA, the corporation is said to be in excess credit, but if the host country has low-tax rate then the corporation has credit deficit (credit limitation) and such corporation is to pay the difference to USA government. In other words, countries that practice credit tax system allow corporations to pay the difference of tax that was paid in host country tax rate to that of home country rate as income is deemed to have been earned in the home country. Wijeweera et al also said, some developed countries such as Canada, Germany, France and Netherlands use territorial tax system where corporations from these countries are exempted to pay taxes on dividends received from a foreign subsidiary in the home country and have to pay the host country taxes only.

These differentials in tax system and rates combined with tax incentives provide MNEs with opportunities to avoid payment of taxes through complicated accounting mechanism, transfer-pricing and internal capitalization (internal debt) arrangements. Wamser (2008) reported that when a host country has high-tax rate than a home country, then internal debt arrangement is a reasonable situation to reduce taxable profits as interest payable on loans is a deductible expense from the taxable income. As a result, many countries impose some form of restrictions through thin-capitalization rules. Wamser provided German as an example of the EU countries which in 2008 introduced a much stricter rule called 'earnings-stripping rule' in place of the thin-capitalization rule and further amended section 8 (a) of the German Corporate Income Tax Law (KStG) to limit interest deduction if a firm's internal-debt to equity ratio exceed a certain threshold. The rule brought some changes on the behaviour of multinationals which increased accessing external financing than before the changes in legislation. Furthermore, seventeen (17) EU member countries have some form of debt-equity restriction as counter-measures of reducing interest expenses deduction associated with internal debt.

In USA, Altshuler and Hubbard (2001) pointed out the amendment of the Revenue Act in 1986 as a countermeasure of capital flight into tax havens particularly from financial services. Among the developing countries, South Africa enacted thin-capitalization rule in 1995 in its Income Tax Act in order to counter capital flight. Nevertheless, NEPAD-OECD (2009) reported that despite the solid USA laws, $100 billion in revenue left in 2008 through capital flight. The situation is worse in developing countries where $500-800 billion cash has been siphoned out per year into tax haven countries due to lack of necessary legal framework and expertise to counter-act such irregularities.

Many developing countries also give multinationals 'tax holidays' meaning that corporations pay no or little taxes for a certain number of years, Goodspeed (2006). Recognizing this fact, some developed countries that use worldwide system allow their corporations to credit such tax holidays as they deem such tax breaks as tax paid. Such practices (sometimes called tax sparing) have encouraged MNEs to force host countries to offer them tax breaks that eventually lead to transfer-pricing abuses after the end of tax-break. For example, many African countries have lost corporate tax revenues due to tax reliefs given to mining corporations and tax evasion practices such as transfer-pricing. Tanzania provides a good example where $1 million corporate tax revenue was received from $189 million taxable income between 2002 and 2007 from two Gold companies because of manipulation of tax bases through over-declaration of losses by either erroneously claiming or early charging of the additional tax allowance, (TWNA, 2009).

The issue of shifting profits through transfer-pricing is not only common to developing countries but even to developed economies. OECD define transfer prices as prices attached to transactions that occur between enterprises that are related, which differ from those transactions made between independent enterprises. Such transactions might take many forms such as input from a subsidiary to a parent company or another subsidiary of the same group, sale of trademark by a parent company to a subsidiary among other forms.

Transfer prices are widely common under territorial (or exemption) tax system as profits are transferred out of the high-tax countries into the low tax countries. Worldwide tax system tries to eliminate incentive of shifting income since countries impose taxes on income from MNEs regardless of source at home country rate. Although worldwide tax system tries to eliminate transfer prices, however, complications arise on computation of credit as other countries use 'mixer' of companies in aggregating average income from the foreign countries to be credited while others use 'basket' companies in averaging the income. Therefore MNEs can transfer profits from high-tax rate into low-tax rate countries in order to obtain full credit.

In order to counter tax evasion through transfer prices, OECD member states developed a set of transfer pricing rules referred to as the 'arm's length principle'. The principle was adopted under Article 9 of the OECD Model Tax Convention which ensures that any commercial or financial relations that are associated by related enterprises in the same group of MNE are expected to be similar to those of independent enterprises. According to OECD guidelines on transfer-pricing, if transactions between associated enterprises deviate from what the open market would demand, then arm's length principle can be applied by the tax affected country. Two arm's length methods are mostly applied by countries in dealing with transfer pricing, which are profit split method and transaction net margin method, Sinanga (2008). However, governments are free to enter into 'Advanced Pricing Arrangement' (APA) that can satisfy them and the MNEs, provided they are complying with the arm's length principle, as the two methods mentioned might not be suitable for every possible situation. The arrangement allows MNEs to use the mutually agreed upon methodology to set transfer prices for the firm either unilaterally (between the firm and one tax administration) or bilateral (between two tax administrations and the firm). For example, APAs have been possible in some developed countries such as Netherlands, USA and Germany.

Some developing countries like Indonesia use Income Tax Law provisions under Article 18(2) and (3) of Law number 17 of the year 2000 to deal with transfer pricing problems, Sinanga (2008). In South Africa, transfer pricing rules are under Section 31 of Income Tax Act enacted in 1995, which grant the Commissioner discretion powers to adjust the consideration for tax purpose if an actual price of a supply or acquisition of goods and services in terms of an international agreement between connected persons is less or greater than the price that would have been set between independent parties, SARS (1999). Other than South Africa, most African countries lag behind in enacting necessary laws to uncover such tax irregularities either because of lack of expertise or resources hence loss of tax revenues.

Another way countries choose not to lose revenue from MNEs is by applying withholding taxes on dividends paid to shareholders, interest payments, royalties and fees paid to consultants as such income might easily escape taxes from both host and home countries. It is a known fact that most countries treat corporations and shareholders as distinct taxpayers, therefore dividends that accrue to the shareholders from corporations is taxed differently through withholding tax. And the rate of withholding tax differs from country to country depending on the double taxation treaty in place, Fernandez and Pope (2002). As such countries are supposed to be guided by two general principles provided by OECD Model and UN Model Convention on double taxation which states that (1) the tax payer of withholding taxes should only be non-resident who has no permanent establishment or fixed base in the source country; (2) permanent establishment should be levied normal income not withholding taxes.

In line with these principles, China enacted a law that provides foreign enterprises which have no permanent establishment or fixed place but derives interest, dividends, royalties and other income from sources in it to pay withholding tax at a rate of 20% on such income. Some developing countries apply withholding tax rate in the range between 10% -15% such as South Africa and Burkina Faso while others tax at the rate as higher as 30% such as Mexico, Otto et al (2006).

Among the developed countries, the double taxation agreements of Australia with USA and also with Netherlands provide good examples where Australian and USA agreement provide 15% withholding tax rate whereas Netherlands subsidiaries of Australian corporations would withhold at 5% rate, Fernandez and Pope (2002). Without tax treaties, it is obvious that governments may freely tax corporations and might be tantamount to double taxation.

Given the growing importance of FDI in the services sector particularly in finance, countries tax financial services differently from manufacturing sector or mining sector for reasons that interest income is a normal course of business in banking, Goodspeed (2006). Usually, certain laws that might have an effect on manufacturing sector do not have effect of financial services. With increased growth in Financial Sector, different countries have enacted or made some amendments to their tax laws in order to avoid tax erosion from this sector. The most notable one is USA which made amendments to Sub-Part F of Revenue Act in 1986, which required financial services income to face US tax rate on the margin in all locations, Altshuler and Hubbard (2001). Following the 1986 Revenue Act amendment, Altshuler and Hubbard found that US corporations in financial services changed their behaviour in locations of their subsidiaries' assets with less sensitivity to tax rate differentials compared to the period before 1986.

Chapter Three

3.0 Taxation of Foreign Investment in Malawi

Countries have two key policy objectives when pursuing taxation of multinationals. The first objective is allowing MNEs to pay their fair share of tax revenues by enacting complex tax avoidance laws. Alternatively, enacting tax laws that will enable the government to benefit through increased employment technology diffusion, increased capital, increased trade and improved skills but forgo some tax revenues by enacting tax laws that are favourable to attract more investments. Many countries are always caught between meeting the two outlined objectives and many countries appear to favour the second objective. Likewise, Malawi's taxation of foreign investments is inclined towards the second option though the government is trying the best to strike the balance between the two objectives.

In general, taxation in Malawi is regulated by the Taxation Act as a main legal framework and is provided under section 41 (1) of the Constitution of Malawi. Furthermore, the remaining fiscal terms are set out in Value Added Tax (VAT) Act, the Export Processing Zone (EPZ) Act, if the EPZ status is granted, the Customs and Excise Act and Mines and Minerals Act if the investment falls under the mining sector. Investment Promotion Act also provides a certain level of clarification in cases where Acts appear to be contradictory to one another.

Under the two broad genres of taxation system mentioned in chapter two, Malawi's tax system is categorized under source based (territorial) tax system, where income sourced within Malawi regardless of residence of taxpayer is subject to Malawi tax. Therefore taxation of non-resident (be person or corporation) conducting trade and derives income within Malawi are taxed according to the relevant sections provided under Taxation Act depending on the nature of business. According to Section 2 of Taxation Act, a resident is an individual who has stayed in Malawi for an aggregate of 183 days or more in any year of assessment or any company incorporated in Malawi, otherwise they are non-residents. The taxation system also depends on some factors that were mentioned in chapter two such as economic contribution; growth pattern; market-orientation among others together with the key objective policy mentioned earlier.

3.1 Corporate Tax

The Taxation Act provides three core arrangements on corporate tax, with variations on each arrangement. The corporate tax rates are provided under the eleventh schedule of the Taxation Act where corporations that are carrying business in Malawi or businesses operated by foreign controlled corporations under Sections 56 and 57 are taxed at 30 percent so long as they are incorporated under the laws of Malawi, whereas the additional 5 percent is levied in respect to all corporations that are not incorporated in Malawi. In other words, branches of foreign corporations are taxed at 35 percent corporate tax rate on their taxable income. The taxable income is deemed to be all income that is sourced and accrued to a corporation from Malawi including capital gains after subtracting all deductible expenses and allowances.

The other two corporate tax rate arrangements are designed to attract investment in Malawi especially in special economic zones and priority industries for increasing exports and foreign exchange. According to eleventh schedule Section C subsection (i) and (ii) state that corporations operating in Export Processing Zone (EPZ), designed by Minister of Finance and published in Malawi Gazette is to pay corporate tax at zero percent rate and those operating in the priority industries are to pay taxes at zero percent rate for the period not exceeding ten years and 15 percent thereafter. The problem that arises from these two corporate tax rate arrangements is that most investors, both local and foreign, are interested to be given either EPZ status or priority industry status and definitely make it difficult to enforce tax liabilities.

According to the Act, capital gains are taxed as ordinary income depending on whether the assets had capital allowance incentives. Capital gains that are accrued as a result of involuntary conversions within 18 months of acquiring an asset are allowed to be differed from taxation until after 18 months. For the capital gains that are accrued to a person or company that disposes shares of company listed on stock exchange are not taxable provided the shares were held for period of more than 12 months.

Though Malawi does not use worldwide tax system, income derived from foreign corporations with head office in Malawi are allowed to credit their foreign taxes against income tax in Malawi upon repatriation of such income subject to satisfactory evidence, even in the absence of the tax treaty and provided such taxable income may not exceed the Malawi tax determined at the average effective rate. However, depending on this tax rule which is a feature under the worldwide tax system, the repatriated income may be taxed both in the host country where income was derived and also in Malawi if there is insufficient evidence.

Sometimes taxation of the services and mining sector sometimes differ from those applicable to the manufacturing sector. According to the Law number 5 of 1997 under Income Tax, life insurance businesses that are operating in Malawi, the rate of 21 percent is applicable on their taxable income accrued or sourced within Malawi. Although life insurance has different tax rates, all other service businesses are taxed at corporate rate similar to the other sectors of the economy.

Notwithstanding this fiscal term, corporate tax rate is also determined by Cabinet Approvals if the investment appears to make important fiscal contribution, such as foreign exchange earnings among others. Although Taxation Act does not grant cabinet approvals for corporate rate, but in 2007 cabinet approved and executed development agreement with Paladin (Africa) Limited a reduced corporate tax rate of 27.5 percent from 30 percent in exchange of holding 15 percent shares in the company. Such fiscal terms bring a high degree of uncertainty to tax laws because interested investors that are to set up either a branch or incorporated in Malawi may seek to enter into confidential agreements for their investment with Malawi Government to acquire special tax rates that are outside the statutory framework. The problem is that taxes may be eroded through many tax reliefs for a low percentage of shareholding in such companies.

3.2 Withholding Taxes

The Taxation Act provides that every person who makes payment in the form of interest, royalties, dividends, rents and fees to a consultant provided such a person has no permanent establishment in Malawi, or has no evidence as a registered taxpayer; withholding tax should be imposed on the gross income for such a person. The rate of withholding taxes varies according to tax treaties and type of such income. Under Section 102A of 2005 amendment, dividends distributed by a subsidiary to a related company or a shareholder not a resident in Malawi; a rate of 10 percent is applied to such income unless the rate is reduced under appropriate tax treaty.

Corporations are obliged to withhold 20 percent for payments made to interest (excluding from stocks or bonds or loans from Malawi Government or African Development) and royalties to non-residents but branches of a foreign controlled company are exempted from applying withholding tax when repatriating their income. Companies are also obliged to withhold 10 percent on passive income such as rents, fees to consultants and commissions that are deemed to be sourced from a source within Malawi.

For payments of dividends and interests to shareholders that are from treaty countries with Malawi, a corporation would under Malawi rules, be obliged to withhold tax on such income at appropriate rate prescribed by the treaty. The other notable difference is payment that occurs to non-resident contractors, who are to incur 15 percent withholding tax instead of 4 percent applied to resident contractors. This tax policy was designed to attract more contractors to be incorporated in Malawi.

Under development agreement with Paladin (Africa) Limited, the company is not obliged to withhold any tax on dividends, interest, royalties, fees and rents when making payment to non-residents. This fiscal term may encourage tax avoidance practice where income may be shifted through high interest payments, high charges on foreign consultant fees and royalties thereby leaving the company in unprofitable situation for its life-time in Malawi.

3.3.0 Anti-Avoidance Tax Measures

Globalization progress has brought large share of world trade to be transacted through transfer of goods, intangibles and services between or within multinationals or related persons. The business transactions that are conducted within MNE group or foreign affiliated person have the potential of shifting income from the high tax into low tax jurisdiction to reduce overall tax liability. There are commonly three techniques that are used to reduce taxable income, which are (i) transfer pricing, (ii) internal debt between associated enterprises and (iii) deferral of profits by controlled foreign companies in the low tax countries.

3.3.1 Transfer Pricing Rules

Transfer pricing rules have been introduced and enacted into legislation effective 1st July 2009. The law has been enacted to give power to tax authority to apply arm's length principle to transactions between related parties where non-arm's length transfer pricing is believed to exist. Before 1st July 2009, tax authorities had no specific transfer pricing rules, but instead Section 56, subsections (5) and (6) of Law number 4 of 1995 of the Taxation Act was used. Section 56 (6) empowered the Commissioner of the tax authority to adjust taxable income of a person or corporation by determining a market value of goods, properly or services that have been sold, exported, transferred or disposed off at a value lower than the market value. Although the section appeared to be closer to transfer pricing rule, there were no clear guidelines that could be used by authorities to enforce such regulation.

3.3.2 Thin Capitalization Rule

Until now, there is no legislation in the Laws of Malawi on thin capitalization. However, the tax authorities are guided on case basis or agreement between investor and Malawi Government. There are certain agreements where a loan interest paid to non-Malawi related party (being parent or subsidiary) is deemed as dividends when the debt-to-equity ratio exceeds 3:1 while others such as the case of Paladin (Africa) Limited development agreement, a tax will be imposed on loan interest payment as dividend when the debt-to-equity ratio will exceed 4:1.

3.3.3 Controlled Foreign Company Rule

As Malawi does not use worldwide tax system, there is no legislation enacted relating to Controlled Foreign Companies (CFC) income in the tax haven countries. Therefore, corporations that have subsidiaries or branches abroad and earn active or passive income can defer repatriation of their income as dividends for unspecified period without breaking any tax law.

Chapter Four

4.0 Taxation of Foreign Investments in Japan

The fundamental authority for taxation in Japan is derived from the constitution of Japan under Articles 30 and 84. The Articles provide the basic principles on who to pay tax and set out procedures for tax in the legislative form. Therefore, all domestic legislations such as Income Tax Law, Consumption Tax Law among other tax laws are set out according to Articles 30 and 84 of the Constitution of Japan.

Besides the constitution providing principles for domestic tax legislation, Japan also align its domestic tax legislation to OECD Model and United Nations (UN) model Tax Convention in order to eliminate double taxation, prevent fiscal evasion and discrimination on the ground of nationality. In general, there is a relationship among domestic tax laws with Japanese constitution and Tax Conventions in order to reduce conflictions in taxation.

Overall taxation in Japan is comprised of national and local taxes. National taxes are subdivided into direct and indirect taxes, while local taxes include those from cities, towns and prefectures. Both resident and non-residents are required to pay same taxes subject to same conditions. Under Japan tax laws, a resident is defined as a person who has a domicile or residence for one year or more in Japan or corporation that has a head office located in Japan. Hence, a person without a domicile or corporation without head office in Japan is referred to as non-resident.

4.1 Corporate Tax

Japan collects taxes using worldwide tax system, where all residents and domestic corporations are liable to pay taxes on income that has risen within or outside Japan. Corporate Tax Law and Local Tax Law are two domestic legislations that are used in collecting taxes from corporations that are liable for corporate income taxes to Japanese government.

And according to the Corporate Tax Law, all domestic corporations are liable to pay tax on their worldwide income while foreign corporations are to pay taxes on income that is derived from sources within Japan. Article 66 or 143 of Corporate Tax Law, Articles 51, 72-24-7 and 314-3 of Local Tax Law and Articles 2 and 9 of the Special Local Corporate Tax Law require all domestic or foreign corporations to pay effective tax rate of approximately 40 percent.

Japan Corporation Tax Law provides relief against international double taxation through foreign tax credit, a foreign dividend exclusion system introduced in 2009 and tax treaties. Japan introduced a foreign tax credit system in 1953 and revised the system in 1962 by introducing indirect foreign tax credit. According to foreign tax credit system, a corporation that has a foreign company is eligible to deduct amount of corporate taxes paid in host country against taxes borne by the income which the corporation has received due in Japan. For example, a company operating in German has to pay 25 percent rate corporate tax on its income to German Government, and when the income has been repatriated to Japanese shareholders, the shareholders are eligible to deduct taxes paid in German and pay the difference on 30 percent due to Japan. In other words, the Japanese shareholders are to pay difference on income derived from foreign corporation between German tax rate and Japan tax rate. This credit system is applicable to income received by Japanese domestic corporations holding less than 25 percent of the foreign companies' shares.

The 2009 foreign dividend exclusion system was enacted to facilitate repatriation of foreign earnings to Japan. Under the system, all the dividends from a foreign subsidiary are exempted from the domestic parent's corporation taxable income. In addition, the domestic parent corporation has to include 5 percent of the dividend from its foreign subsidiary whereas 95 percent is allowed to be deducted from the taxable income. A qualifying subsidiary for foreign dividend exclusion is the one in which a domestic corporation holds at least 25 percent of its shares for more than 6 continuous months prior to the date of dividend declaration. The allowable tax credit against Japanese tax is not only limited to corporation tax (or income tax) but it also extends to local taxes such as inhabitant tax, business tax that are payable to prefectures, municipals and cities in any other country other than Japan.

Although Japan has foreign tax credit, however, the system exclude from the tax relief all taxes paid on tax rate higher than 50 percent (other than interest) or more than 10 percent for interest. The exclusion further includes tax rates or amounts that are optionally decided by the taxpayer; taxes paid due to secondary adjustment; taxes that arise due to underestimation during filing or failure of filing by due date; taxes arising because of due date optionally decided by the taxpayer and taxes on income that are derived from unusual transactions such as back-to-back loans or loan asset assignment carried out because of special relationship between related parties or their third parties.

Foreign Corporations with a place of business such as permanent establishments or fixed place in Japan and derive income from Japan sources have an obligation to pay corporate taxes on the said income accrued to their business in the same manner as applied to domestic corporations. Furthermore, foreign companies not incorporated in the laws of Japan have to pay corporate taxes on their income accrued to them from utilization or possession of assets or transfer of real assets in Japan. The foreign corporations are also liable to pay local taxes in accordance to Local Tax Law and Special Local Corporation Tax Law.

4.2 Withholding Taxes

Apart from the corporate tax imposed on domestic or foreign corporations, Japan Income Tax Law Article 212 requires enterprises to impose withholding tax on income that accrue to non-residents or foreign corporations except those having permanent establishment or fixed place of business in Japan. The said income should arise in the form of dividends, interest, royalties, prize money on lottery-decked deposit among others and payable to a said non-residents. There is also withholding tax on capital gains from listed shares on individuals who have permanent establishment in Japan or otherwise. The rate on withholding tax varies depending on the type and scope of income, and ranges from 7 percent to 20 percent. For example, dividends distributed to a foreign investor in the foreign country, a 15 percent withholding tax rate is imposed but dividends from certain listed shares have withholding tax of 7 percent. However, reduced withholding tax rates in the range of zero percent to 15 percent are imposed depending on the bilateral tax treaties that Japan signed with other countries. As of October 2008, Japan had 45 tax treaties in force and applicable to 56 countries.

Besides corporate taxes and local taxes, foreign corporations are also obliged to pay other taxes (indirect taxes) such as consumption tax, property tax among others, that are required by Law according to the nature of the business.

4.3.0 Tax Anti-Avoidance Measures

There are many tax anti-avoidance measures that countries use to counteract tax evasion. For international taxation, Japan has four main tax anti-avoidance measures which are transfer pricing rules, thin capitalization rules, foreign controlled companies (CFC) rules and Anti-avoidance rule on corporate inversion.

4.3.1 Transfer Pricing Rules

Japan has a legal instrument that protects domestic tax base from evasion through commercial or financial transactions between related parties without arm’s length standard. This means that transactions between related parties should be done completely as independent parties. The legislation for transfer pricing taxation was introduced under Special Taxation Measures, Article 66 (4) of the Japanese Special Tax Law of 1986 in order to recapture income that is being shifted abroad from Japanese jurisdiction.

Tax authorities are empowered to impose arm's length principle when the corporation's revenue has been shifted or expenses increased thereby decreasing the taxable income, because of the transactions between the corporation and foreign related person or company that did not apply arm's length price. From Japanese perspective, a foreign related person means a foreign corporation having a control over the other or being had a control by the other either through holding at least 50 percent of stocks directly or indirectly or substantive dominance relationship or combination of the two.

In order to establish arm's length price (ALP) that can be used in the transaction between independent entities, two main methods are used which are (i) traditional transaction method and (ii) transactional profit methods. Traditional transactional methods that are used include comparable uncontrolled price (CUP) method, resale price method and cost-plus method. Provided that the three basic traditional transactional methods are difficult to apply, transactional profit methods that include profit split method and transactional net margin method (TNMM) may be executed under prescription of Cabinet Order. Besides these transfer pricing methods, other methods are also used such as presumptive arm's length price when accounting books and documents are not submitted without delay upon request by tax official. Furthermore, prices can be determined by consulting intermediate third party; requesting documentation from overseas related person; inquiring information from a comparable enterprise and extending time limit for correction or determination to 6 years.

4.3.2 Thin Capitalization Rules

Generally, thin capitalization refers to an imbalance between the level of foreign equity of capital and debt that a subsidiary has been funded to finance its operations. Japan introduced a thin capitalization rule in 1992 to address the problem of interest deduction from taxable income of the subsidiary where the level of debt financing is greater than capital equity.

The legislation roughly says that if a Japanese corporation borrows from its controlling shareholders overseas or third party to finance its operations an amount more than three times of its equity, interest payments on the excess portion of the borrowing exceeding such 3:1 ratio of debt-to- equity will not be a deductible expense. Although the debt-to-equity ratio of 3:1 is a rule, it does not always hold in all cases. In some cases a proxy is used if the company owes its related partners a debt exceeding 3:1 ratio can provide evidence to tax authority to be exempted on some interest provided a comparison with other corporations that belong to similar industry and having similar business have similar debt-to-equity ratio. In such a case, debt interest payment exceeding the said proxy debt-to-equity ratio will not be allowed for deduction.

4.3.3 Controlled Foreign Company (CFC) Rules

As part of preventing erosion of Japanese tax base, Japan introduced and enacted into law the Controlled Foreign Companies (CFC) rule in 1978. The legislation aimed at preventing domestic Japanese corporations to shelter profits into tax haven countries by establishing subsidiaries into those jurisdictions in order to reduce their tax liabilities payable in Japan.

The legislation achieves this by taxing domestic parent corporation income by adding up the income of the CFC despite the fact that such profits have not been distributed to the parent company.

Japanese corporations that have at least 5 percent of shares of a foreign corporation whose more than 50 percent shares are held by Japanese residents and corporations and which is taxed effectively at 20 percent or less corporate tax rate in its locating state are subject to CFC rules. In 2009, the CFC rule was included in Special Taxation Measures as Article 66 (6) of the Japanese Special Tax Laws.

As most CFC systems, the Japanese CFC rule also provides exemption. For example, the CFC that does not mainly conduct the businesses such as holding stocks or bonds and that is in banking, insurance, distribution and transportation industry then transacts mainly with unrelated person and is in manufacturing and other industries then whose business locates in the state in which the head office locates are exempted from CFC rules.

4.3.4 Corporate Inversion Rule

The triangular merges may lead to a Japanese corporation to become a subsidiary of a foreign corporation located in a tax haven country. The reorganization through merging may enable the group to reduce its effective tax rate and is referred to as corporate inversion. To prevent tax evasion through corporate inversion, Japan enacted anti-avoidance rules on corporate inversion in 2007. The law requires Japanese shareholders of such foreign corporation to include an appropriate portion of the taxable income of the foreign parent company in their taxable income due to Japan.

Chapter Five

5.0 Conclusion

The paper has provided information on the taxation of the foreign investments in Malawi and Japan. The paper has shown that Malawi as one of the many developing countries is forgoing millions of dollars in revenue through the excessive tax subsidies and tax avoidance practices by MNEs. The paper has reported that Malawi also use discretionary powers through Cabinet Orders besides fiscal tax regimes in taxing foreign investments depending on the fiscal gains from such foreign investments. Furthermore, Malawi lacks predictable tax regime that is credible, transparent and consistent with legislative framework. The inconsistence arise because taxation regime offered by government to foreign investors goes beyond competitive tax rates despite the effort by policymakers to strike the balance between providing taxation rates that can improve domestic resource mobilization and attract investors.

The study has further indicated that Malawi tax system requires some legal provisions that gives powers to tax authorities to enforce tax compliance and auditing as observed in Japanese tax system. The provisions are necessary to insulate profits of corporations from being eroded by foreign investors through complex accounting standards. The paper has clearly shown that administrative policy and well define procedures need to be incorporated in the domestic laws under transfer pricing rules. In addition, Malawi needs to introduce thin capitalization rules, and if necessary CFC rules and corporate inversion rules may be enacted in order to cement all loopholes that may be used by investors to evade payment of taxes.

The paper has also pointed out that Malawi lacks skilled and knowledgeable experts who can audit complex accounts of the multinationals. This problem may also exist in many developing countries which may give room to MNEs to avoid paying taxes through mostly transfer pricing. Unlike Malawi, developed countries like Japan may have well trained international tax examiners and auditors who can expose such malpractices; however this paper focused on Japanese legal system regarding international taxation. Thus I would like to leave this matter to future research.

In contrast to Malawi tax system, Japan uses worldwide tax system as many developed countries. Its international taxation is guided by OECD guidelines and in some instances by UN guidelines which complement domestic tax laws. In order to increase compliance, Japanese tax system has given powers to tax officials to access information on matters relating to taxation within their jurisdiction and some tools to collect information outside their jurisdiction. The study has shown that Japan has necessary legal taxation framework that ensures tax compliance and avoidance of tax evasion from MNEs.

5.1 Recommendations

It is clear that Malawi embarked on a long-term strategy of attracting foreign investments. If Malawi is to continue to attract high levels of the investments, it should offer predictable tax regime that should align with international taxation standards. Malawi should learn such international tax standards from developed countries such as Japan.

Malawi should also consolidate its tax structures to avoid excessive tax incentives that can encourage MNEs to reduce taxable income in order to pay less tax and lead to tax evasion after the expiry of the incentive period. The tax regime should be able to strike the balance of improving domestic revenue mobilization that will finance public provisions and promote environment for further investment.

Malawi tax authority should include provisions on thin capitalization and comprehensive guidelines on transfer pricing in its tax laws in order to seal opportunities that can be used by foreign investors to evade taxes. Transparent rules are necessary due to increase of foreign investment in the country and are already widely used in most developing and developed countries.

Malawi tax authority should also improve administrative capacity by preparing tax officials in the examination and auditing of multinationals through improved skills and knowledge on international taxation.

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