

**JOINT SUBMISSION TO THE  
MALAWI TAX REVIEW TEAM**

**from**

**Economic Association of Malawi**

**Malawi Confederation of Chambers of  
Commerce and Industry**

**Society of Accountants of Malawi**

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## INTRODUCTION

MCCCI, SOCAM and ECAMA have come together to develop a single set of proposals to feed into the Government's tax review process.

We recognise that the current Government is facing a major task to bring the macro-economy back on track. The need to pay off debt incurred in past years when the previous Government was 'off-track' with the IMF, means that there is little scope for net tax revenue reductions in the 2005-06 budget, unless there is a significant reduction in Government expenditure or at least growth of expenditure well within the rate of inflation.

However, the tax review is both welcome and opportune. Malawi needs to look at the structure of the tax system for the coming budget year and for the years beyond when the budgetary position should be quite different, particularly as the Government convinces the IMF and Development partners that it has regained control of its expenditure and used the proceeds of the revenues for developing the economy and addressing poverty. In itself, the tax system and administration of it can be a major factor in building our economy and generating the self-sustaining revenues that will support and underpin the development of this nation. Having a better functioning tax system could even become a competitive advantage for Malawi, bringing forward domestic investment and winning foreign direct investment within the region. Given that Malawi faces considerable structural costs (transportation and crossing borders) in both imports and exports, then we need to have a tax system that is at least as good as our neighbours and in particular that supports investment and trade as the lifeblood of any successful economy.

With an eye to both the immediate constraints and yet also to the need to move the economy to a new level, we have focused our suggestions to those changes that are broadly revenue neutral or revenue enhancing over a three year period, or which are absolutely essential in order to restore the viability and competitiveness of Malawian businesses. The key would be to phase the changes suggested over a period of two to three years in line with an improved budgetary position of the GoM and to redress the significantly higher burden of taxation that has fallen onto the formal tax compliant private sector over the last 4-5 years.

This increased burden has acted as a major drag on investment resulting in significant disinvestments over recent years and limited domestic and international investment. It has also fostered an increased climate of non-compliance as ever more stringent revenue raising measures and tax collection practices have made it ever more difficult to comply and to operate formally. Concessions on tax do not necessarily equate to reduced revenues – much depends on the starting point and the overall context. There are many countries that have reduced rates on certain low yielding taxes to find that the overall tax take has increased. Where compliance is low then more attractive taxes (rates, operation, thresholds) can result in increased revenues. In some cases, such as Capital Gains Tax and even Surtax, sensible adjustments in favour of businesses could increase overall GoM revenues. This requires a degree of boldness that we believe Government will have the will to seize.

The burden of taxation has increasingly fallen on the same group of businesses with significant effects on their profitability and returns on investment. Eventually this impacts on their willingness to continue investing and ultimately whether to continue operating at all. Government has been successful at raising revenues from 17.1% of GDP in 2001/2 to over 22% in 2004/5 with an ultimate target understood to be 25% of GDP. Whilst the percentage point increase may seem small, the effect of increasing revenue to 25% of GDP would be to increase tax revenue by nearly 50% (8%/17.1%) much of which will fall on the same formal tax-compliant businesses as have carried the burden so far.

It is also important for Government and other stakeholders recognise that the formal sector tax-compliant businesses are now at a significant competitive disadvantage in an environment where there is widespread non-compliance by substantial businesses, particularly in the trading sector. Those businesses that do not comply with the proper administration of tax (PAYE, Surtax/VAT, Withholding Taxes) have an immediate cost advantage over those that do. A key policy question is therefore how can the burden of taxation that falls on those businesses that comply and contribute revenues to building this country be shifted onto those that are deliberately or ignorantly not complying? Increasing the incentives to comply with more favourable taxation treatment, would reward compliance, combined with a shift of the pressure to comply on the non-compliant shadow private sector. If this shift of the burden is not achieved soon, then Malawi will see an increasing informalisation of the business community and increased culture of non-compliance thereby reducing medium-term revenues.

It is worth noting that because of lack of data and a shortage of time, this private sector proposal does not take into account two important sets of considerations. First, it is not based upon a view about Malawi's competitiveness with regard to countries that compete for investment. We would suggest that in order to foster investment Malawi needs to offer the best tax regime in the region. We understand that the consultants will be "Conduct[ing] a comparison of Malawi's marginal effective tax rate with key regional competitors", and look forward to examining the results of this study.

Second, the private sector has not had access to detailed data about MRA's tax collection by type of tax. We thus are unable to assess the revenue implications of the changes that we have proposed, but would expect this analysis to be made available so that the assessments of revenue implications of different measures can be viewed transparently.

Whilst this review is inevitably focused on revenue, the key problem to be addressed by Government is not revenue raising (budget for 2004/5 is almost 25% more than 2003/4 which has already seen significant and painful increases) but on control of government expenditure. The budget deficit is a function of the past over-spending not fundamentally the lack of revenue. As with any business that has expenditure exceeding its revenue, the first actions must be to cut back expenditures significantly and quickly. Increases in the expenditure budget for 2005/6 at or above the level of inflation would not be welcomed by private sector. There needs to be a considerable reduction in the increase in government expenditure to well below inflation and at the least, below the rate of revenue increase budgeted. This would allow more realistic revenue increases to be budgeted, again ideally well below the level of inflation. Too much emphasis on revenue increases in the past have caused damage to the tax compliant private sector.

Finally, we would like to thank the Government for seeking input during the review process. This is a very welcome sign of the increasingly strong cooperation between Government and the private sector. We welcome the opportunity to be involved in the continued consultation process.

## TAX ADMINISTRATION

### Refunds to be Paid within Due Periods

Many tax-compliant businesses are suffering from excessive delays in refunds of tax payments beyond the periods specified in the tax legislation. This is especially problematic in the case of surtax payments where in addition to excessive delays, the system does not allow for a refund claim to be even submitted until three consecutive months of net reclaims. The delays range up to a year in many cases, requiring businesses to borrow millions of Kwacha at excessive interest rates to finance investment and working capital, due to unpaid refunds from Government. This is a form of compulsory interest free lending that costs the lender not the borrower. We understand that Ministry of Finance has recently increased the monthly allocation for refunds from MK 60million to MK 100 million, but this does not appear to be sufficient to clear the large backlog. This hidden liability needs to be properly determined and properly financed.

Some of the problems could be overcome by allowing those business that have demonstrated a good record of tax compliance to move to quarterly accounting of surtax (biggest problem area) as is normal in many other tax regimes. This would improve the efficiency of the system for the businesses and the MRA as it would avoid generating as many claims as offsets are done within the quarter. This would also be more equitable to the taxpayers given that refunds are due but not being paid. As indicated, this would apply to those businesses with a track record, not those that have not been fully compliant. This would give another incentive to be compliant. It would be revenue-neutral as any overpayment creates a liability, which has to be repaid. It would impact on government cashflows within the quarter, but more fairly shares the burden of cashflow between private and public sectors. This will also reduce the cost of tax administration on both sides.

Unlike many other countries, businesses cannot offset payments due from one form of taxation against refunds due from earlier payments of different taxes. Given the long delays experienced and, for many smaller businesses, the near impossibility of getting a refund, then it would only be fair to allow this offsetting, perhaps on an annual basis across certain taxes and only if approved audited accounts have been submitted. Again, this would reward tax compliant businesses, which are at a competitive disadvantage with non-compliant businesses.

Therefore, the private sector requests that:

All tax refunds should be made within the existing time periods specified with no undue delay  
Taxpaying businesses of good standing, that have demonstrated their capacity to remit surtax accurately, should be allowed to move to quarterly accounting

Businesses should be allowed to offset tax due against overdue refunds on other taxes already paid, with necessary safeguards for errors on both sides

### Fair System of Tax Adjudication

The confidence of the business community in the tax system depends on the capacity for fair adjudication in tax disputes between the revenue collection and the business. No matter how good the tax system is on paper, if it is being applied in a discriminatory, unpredictable or unfair manner then investors will have not be attracted to invest. Investors look as much at the tax administration system as much or even more than the tax regime as set out in the statute books. Malawi used to have relatively good relationships between the revenue collection agencies and the business community. However, this has substantially broken down over the last 3-4 years in particular and confidence in the fairness of the tax

administration is at a low point. Unless this is addressed, then Malawi is unlikely to see improved levels of domestic and international investment.

Government establishes the system of taxation through legislation and regulation and then implements that system through the Malawi Revenue Authority (MRA). Taxation is a complex matter and there are situations that require interpretation as the legislation or regulations cannot cover all situations. This interpretation is done at all levels within MRA, including junior or inexperienced officers. This power of interpretation is very wide and at times, goes beyond the intention of the executive as expressed in legislation and regulation. Inevitably there are different interpretations and whilst these can sometimes be resolved through further investigation and dialogue, the more recent trend has been for businesses to be given assessments (increasingly without even discussion first) with the threat of asset seizure.

In such situations, there is a procedure to appeal to a higher level within MRA, right up to the Commissioners and the Commissioner General. There is a provision for the appointment of special tax commissioners, but this has never been used. The overall tax adjudication process has several obvious flaws.

First and most crucial is that the MRA is effectively prosecutor and judge in its own cases. This breaks all the basic principles of natural justice. It is very difficult for any organisation to find that its own officers were incorrect in their assessments compared to the view of an outside party. This has been made worse by the pressures for revenue collection on the MRA and when there are rewards for hitting revenue collection targets.

Secondly, MRA has significant powers of retention, detention and seizure. If it is in dispute with a party it can effectively hold the businesses assets and sit tight knowing that delays cost money for the business. Cases are often settled because the business cannot afford to wait any longer.

Finally, although businesses can take the matter to court, the exceptionally high cost of the legal system in Malawi, the absence of dedicated commercial courts and the priority given to other types of cases mean that this is only an option for the largest businesses in major disputes. Effectively the vast majority of businesses, particularly small and medium have only the MRA as the adjudicator.

The establishment of the Office of a Tax Ombudsman with the powers of adjudication in tax cases that have exhausted the route of dialogue and negotiation would be one option. This would allow many businesses to access justice at a realistic cost. If this is not possible at this point in time, then there are other options that separate the prosecution of cases from the adjudication, such as the appointment of independent tax commissioners, training a small number of Tax Magistrates or the implementation of the commercial courts with a tax adjudication mandate.

Whichever route is taken, this independent adjudicating body must have the power to force the MRA and businesses to pay the costs incurred by the other for the delay in settlement of taxes due or for losses incurred due to unfair seizure or impounding of goods/capital. This will ensure that there is pressure on both sides to settle early rather than at present, whereas at present that pressure only falls on the business.

The way in which the tax system is being implemented over recent years has been one of the biggest complaints of the business community and undermined the legitimate tax-compliant business community. Therefore, transferring the powers of tax adjudication from the MRA would be a major step forward in promoting investment and reassuring legitimate taxpaying businesses of the restoration of balance in the administration of the tax system.

It is our belief that this transfer of the adjudication function should be funded out of the share of revenues that accrue to the MRA that it uses to fulfil this function as the transfer would remove one of the tasks that the MRA has to deal with. We also believe that development partners would be willing to assist in such a measure of good governance.

There is a concern that this might result in reduced tax revenues. There are two strong counter arguments. Firstly, if revenue assessments are incorrect and revenue is not due, then arguing to retain a system that levies incorrect tax assessments is saying that revenue collection should occur irrespective of the merits of the case – that cannot be acceptable. Secondly, and related to the first, if the system is seen by investors to be unfair, then it will be a major factor in deterring investment that generates revenue in the short, medium and long term. If Malawi is seen to have a fair system of tax administration, then this will in contrast act as a magnet for investors given the tax administration weaknesses in other jurisdictions. This will even overcome some of the concerns about the overall attractiveness of the tax regime, if it is at least being applied fairly. Malawi can only gain from this separation.

Therefore, the private sector requests that the Government makes a formal commitment to transfer the adjudication function and powers to another tax adjudication body to be operational by December 2005, funded out of current MRA revenue share.

### **Other issues**

More stringent and explicit laws that focus on tax defaulters must be enacted to minimise disadvantaging those businesses that are tax compliant. There also needs to be a stronger and perhaps more independent tax investigation and compliance unit to deal with those businesses that deliberately operate outside the law. Alongside this would be the use of taxpayer grading to reward those businesses that are compliant with a lighter touch regulatory regime and even with more advantageous treatment on tax rates (such as withholding taxes for service companies). Loss of this status would provide a strong incentive to avoid abuse by those companies with a lighter touch regime and encourage compliance by others.

Staff at the Malawi Revenue Authority should be trained to understand how businesses are run for them to understand and appreciate some of the issues better. In this regard, presentations by business leaders and SOCAM members at the Institute of Tax Administration should be arranged on a regular basis.

MRA also needs to take a more risk based approach to compliance with the emphasis on getting the larger amounts of revenue due but not collected rather than extracting the last Kwacha from tax compliant taxpayers.



## BUSINESS TAXATION

### **Income**

It is recommended that the definition of “income” (Section 11 of the Taxation Act) should be reviewed to clearly exclude:

- capital gains, and
- tax-exempt income.

(See below for additional comments on capital gains.)

### **Minimum Taxes**

Minimum taxes are based on turnover and apply where a tax loss has been determined or the computed tax on income is less than the amount payable as minimum tax. The tax acts as a surrogate for a vigorous audit and investigation that should be triggered by the continued declaration of losses by a taxpayer. It also encourages some businesses to declare turnover at a level equivalent to the minimum tax only.

Our strong feeling is therefore that minimum taxes provision should be removed. However, if the minimum tax rates are to be retained, it will be necessary to define “turnover” to exclude tax-exempt income such as dividends, capital gains on disposal of listed assets, non-trading receipts such as grants and donations.

### **Fringe Benefits Tax**

Through an omission in legislative drafting, an agreed reduction in the rate of fringe benefits tax was never enacted. A fringe benefit is defined as “any provision by or on behalf of the employer to an employee of any asset, service or benefit-in-kind if such provision includes an element of personal benefit to the employee”. Fringe benefits tax is payable at the corporate rate of 35 percent and is assessable on the employer.

There is no justification for charging tax on employment costs at rates in excess of the general corporate tax rate of 30%. Accordingly, the rate of tax on fringe benefits should be reduced to 30%, being the corporate tax rate currently applicable.

### **Non-governmental organisations**

The Taxation Act should provide for automatic tax exemption from corporate income tax of all organisations or institutions that are non-governmental. NGOs are invariably established under the Trustees Incorporation Act or under the Companies Act (but limited by guarantee). The underlying problem is both the delays in granting this status and the discretionary nature of this. More transparent criteria and process as well as fixed time limits would be an alternative approach.

### **Tax-exempt receipts**

Ceilings for housing allowance, pension withdrawal benefits and bank interest need to be reviewed and adjusted to levels that reflect Malawi’s current prices and economic situation.

## ALLOWABLE DEDUCTIONS

### (TO DETERMINE TAXABLE INCOME)

#### General Deduction Formula

All expenses incurred during the year of assessment wholly and exclusively and necessarily in the production of income or for purposes of a taxpayer's trade are deductible from assessable income to determine the taxpayer's taxable income.

It is recommended to insert the word "assessable" immediately before the word "income" at the end of Section 28(1). However the following expenses should be considered as eligible for tax relief:

#### Social Investment and Expenditure including HIV/AIDS

There was a recent high profile dispute between a taxpayer and the MRA over the treatment of their expenditure on their workplace HIV/AIDS programme. The Government of Malawi already has a clear policy on this, as set out in the National HIV/AIDS Policy. Section 3.7 of the Appendix notes that, "tax legislation shall be revised to provide incentives for employers who provide comprehensive HIV/AIDS programmes in their organizations."<sup>1</sup>

Given the constrained level of Government budgets and the scale of the problems facing the nation, it would benefit all parties if business expenditure on all social infrastructure (clinics, schools, boreholes, road improvements, staff housing etc.) and social welfare expenditure (HIV/AIDS counselling etc.) were more explicitly recognised as allowable for tax purposes and even encouraged with additional incentives in some areas.

#### Pension Fund Contributions

The Government's National Economic Empowerment Policy notes that Malawians tend not to save and invest in the domestic economy. One reason for this would seem to be the unfavourable tax treatment of savings. We would therefore recommend changes to encourage saving, including by making contributions to pension funds and withholding tax on bank interest.

Currently, there is a tax exemption for the first K3,000 per annum contributed to an approved pension fund. This allowance is derisory, amounting to tax relief of about \$0.90 per month and fails to encourage a savings mindset or to provide funds for re-investment by pension providers.

It is suggested that the employees' contribution to an approved pension fund should be eligible for tax relief to a maximum of K48,000 per annum. An employer should be allowed a sum not exceeding K96,000 or twice the employee's contribution.

#### Mortgage Interest

Mortgage interest on owner occupied housing loans should be allowed as a deduction.

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<sup>1</sup> [http://www.unaids.org/html/pub/topics/human-rights/malawi\\_national\\_policy\\_en\\_pdf.pdf](http://www.unaids.org/html/pub/topics/human-rights/malawi_national_policy_en_pdf.pdf), p. 33.

## **Life Insurance Premiums**

Life insurance premiums to an approved insurance company should be allowed as a deduction to the extent of the premiums paid or a maximum of K24,000 per annum.

## **Payment Of Lump Sums For Annuities**

Section 40 (Taxation Act) allows a deduction of an annuity, allowance or pension paid during the year of assessment:

- to a former employee, on the grounds of ill-health, infirmity or old age; or
- to any person who is/was dependent for his maintenance upon the former employee...provided that the amount allowed shall not exceed in respect of dependent persons the sum of K1,200

It is recommended that the amount deductible should be increased to an amount not exceeding K250,000.

## **Additional Transport Allowance**

Malawi businesses suffer from the geographic situation of the country, which imposes very high transport costs on both inputs and outputs. In a survey of 61 (developed and developing) countries, Malawi had the fourth highest proportion of transport costs as a percentage of landed cost of goods for all exports.<sup>2</sup> The cost of shipping goods for export is a major constraint on economic growth and until it is redressed, then exporting should be encouraged through the taxation system.

The Government has already recognised this constraint, by allowing an additional deduction for transport costs pertaining to exports (under section 41B of the Act) up to the border. In light of the very high costs faced by businesses, we recommend that this additional allowance be increased from 25% of transport costs to 50% of costs.

## **Allowable donations**

Only donations to those institutions or organisations approved by the Minister qualify for tax relief. The process of obtaining Ministerial approval is cumbersome and time consuming.

Accordingly it is recommended that any donation of K5,000 and above that is made by the taxpayer during the year of assessment to an institution or organisation established under the Trustees Incorporation Act, or established under the Companies Act (but limited by guarantee), should be deductible against income. The assessment of an organisation's fitness to benefit from this special status should be when applying for that status not when receiving a gift. In circumstances outlined above, approval by the Minister should be considered an unnecessary use of Ministerial time.

## **Assessed Losses Brought Forward**

At present, losses can be carried forward indefinitely. We would propose that loss carry-forwards are limited, with our proposal being for up to seven years, but with three years of loss carry-back allowable.

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<sup>2</sup> Radelet, Steven and Jeffrey Sachs. *Shipping Costs, Manufactured Exports, and Economic Growth* (1998) Online. Available at [www2.cid.harvard.edu/hiidpapers/shipcost.pdf](http://www2.cid.harvard.edu/hiidpapers/shipcost.pdf) [Accessed 9 December 2004].

Under this proposal, any assessed loss relating to the prior year that is agreed and is brought forward into the current period would be set off against the taxable profit of the taxpayer until fully relieved, provided that this will not be carried forward from year to year beyond a consecutive period of seven years from the date first established.

The loss carry-back would enable a taxpayer to set off existing tax losses against prior years' taxable profit or against taxable profits relating to a period not exceeding three years. Any unrelieved losses would be carried forward and available for set off against future taxable profit to the limit described above.

## CAPITAL ALLOWANCES/DEPRECIATION

### **Commercial Buildings**

Currently, commercial premises do not give rise to depreciation for tax purposes. This is very unusual internationally and constrains the development of commercial property investment and improvements.

Paragraph 8(3) - Second Schedule as read in support of Section 33 must be amended to include "buildings used for commercial purposes" as assets qualifying for capital allowances.

### **Information Technology**

Capital allowances are claimed on reducing balance basis on qualifying assets. Today, computer and other IT hardware is depreciated at a rate of 20% per annum. It is not realistic to expect businesses to replace their computers and related equipment only once in five years. Instead, we recommend that the reducing balance rate should be 33 1/3% or even converted to straight-line basis to encourage businesses to reinvest in their equipment rather than waiting for obsolescence.

The cost of software that is purchased and used in the business for processing data must be treated as wholly tax deductible with the proviso that where the cost is significant (a threshold could be set), it should be capitalised and written off over the period of the licence or usage, whichever is preferred.

### **Economic development areas**

In order to promote economic growth through out the country, Government must establish development areas. Any expenditure that is incurred in the provision or construction of infrastructure of a permanent nature, and is used for commercial purposes in that designated area, must be eligible for 100% write off.

### **Investment allowances**

This is currently provided and deducted from the cost of the asset to arrive at the tax written down value on which subsequent claims of annual allowances is based. It is recommended that the investment allowance should be granted as an outright incentive, that is, not as a deduction from the capital value of the asset.

More favourable investment allowance rates would encourage investment in revenue generating fixed assets. Businesses do not invest if there is no income stream associated with the investment and this would improve the revenues for businesses and government if a more generous set of allowances were in place. Allowances are also favoured as they are universal and do not require inefficient and unpredictable discretionary process of application and granting. This makes them more likely to benefit small and medium businesses who either do not know how to apply for special incentives or do not have the capacity to do so. Receipt of the allowances also occurs after the investment has been made and audited accounts presented, further encouraging compliance.

## CAPITAL GAINS

Taxing capital gains in a manner similar to trading or employment income is inappropriate, as this acts as a disincentive. Accordingly, it is recommended that if it is intended to continue charging tax on capital gains, it should be taxable under a separate tax heading or subsection, instead of being incorporated in Section 11. All provisions relating to the taxation of capital gains should be consolidated into one part of the Act if not in a separate Act all together.

Further recommendations are as follows:

### **Tax rate**

A separate tax rate for determining tax on capital gains must be introduced. In countries within the Southern African region, capital gains are generally taxable at a rate not exceeding 15%, instead of 30% on companies or as high as 40% on individuals. High rates discourage compliance and probably lead to lower overall revenues in this area.

### **Inflation factors/Indexation**

Inflation using rates were last provided by the Commissioner of Taxes in a Government Gazette Notice No 67 dated December 31, 1998, and became effective January 1, 1999. It has thus been more than five years since inflation rates have been reviewed. There is an urgent need to review these in line with economic and market indicators for equity and revenue raising reasons. The responsibility for reviewing should be vested in the hands of independent assessors in order to ensure impartiality, reasonableness and commitment, perhaps the Reserve Bank and published within a statutorily defined period.

### **Rollover relief**

Rollover relief is a means by which liability to capital gains tax is deferred. The essential feature of roll-over relief is that a gain which would otherwise have arisen on the occurrence of a taxable event for capital gains tax purposes is deferred, or rolled over, until there is a subsequent disposal of the asset concerned.

A provision for rollover relief should be incorporated setting out specific requirements in order to qualify for tax relief.

Guidelines necessary for conversion of one asset to another should be put in place to ensure that proceeds of disposal of the first property that are intended to be reinvested in the second property should be treated as tax exempt.

## WITHHOLDING TAXES

The rates of withholding tax being applied do not reflect the level of tax compliance by the recipient or the importance of the economic sector. This is true with respect to professional services income or agricultural income where the rates applied are punitive. Collection of withholding taxes on small amounts, such as casual labour, smallholder crops and other transactions is more costly to administer than the revenue gained. This costs both the business and the MRA, so that both sides lose. Accordingly, it is recommended as follows:

### **Withholding taxes on farm products**

The elimination of withholding tax on primary products within the current minimum income tax threshold (up to K36,000/p.a.) has already been agreed by the MRA/Ministry of Finance, as explained at National Action Group Forum meetings. Advice from the MRA has been that individual industries should arrange with the MRA to effect this decision administratively.

A legislative amendment would be a simpler and clearer way of effecting this exemption.

It would also be beneficial for withholding taxes to be severely restricted on all agricultural crops to encourage production and to encourage the development of the majority rural population. This would also contribute to food security which has been a persistent drag on the overall economy and Government budget.

### **Restriction on businesses mainly involved in providing professional services**

The restriction in Section 102A(1) proviso on professional fees derived from services rendered in the normal course of business should be removed, where the fees constitute not less than 80% of annual turnover.

### **Reduced rates for compliant taxpayers**

In order to encourage compliance, it is recommended that in cases where the taxpayer is registered for tax, the withholding tax rate to be reduced to a figure of between 5-7%. In the case of non-registered taxpayers, the current rate should be maintained. At present, the rate of 20% is set to catch small-scale self-employed operators who do not declare income for tax. But for a compliant professional services firm, the effect is that their taxable profits are assumed to be 66.6% of turnover (20/30%). This results in significant overpayment of tax, which then has to be reclaimed at the year end and often not refunded within a reasonable period.

### **Bank interest**

Administratively, it is difficult to apply withholding tax on bank interest income and tends to fall on small savers who cannot adjust their affairs to avoid it. Therefore, it should be eliminated. For the sake of consistency and fairness withholding tax should also be eliminated on government securities.

### **Withholding tax exemption certificates (WHTEC)**

New businesses that are permanently established and are applying for WHTEC should be eligible for issuance on the grounds of being newly established and to encourage compliance.

## PROVISIONAL TAX

Businesses have 14 days from the end of their financial year to calculate their overall tax bill for the year and to pay 90% of the estimated amount of tax due for that year as provisional tax (including quarterly payments already made) or face significant penalties for under payment. Whilst there are complementary issues of cashflow and realisation of profits, it is not realistic to expect businesses to be able to calculate their tax bill so soon after the year-end, which is always one of the busiest times of the year for management. Calculating tax requires businesses to:

have accurate figures for all costs, including accruals for invoices not yet received, consolidate reports from branches/subsidiaries/business units, have an accurate total for revenues, taking into account surtax and withholding taxes, have calculations for depreciation, capital allowances and other taxation issues such as net payments made (provisional tax and withholding taxes) and carry forward reliefs etc.

As a comparison, the requirement is the same as if government as a whole, single ministries or even departments within ministries or agencies were required to calculate expenditures within 10% of the final audited total within 14 days of the budget year end. Businesses then have to do the same for revenues and then make the necessary tax calculations.

The impact is particularly unfair on small and medium businesses as very few have in-house accounting or taxation expertise. Even businesses with in-house accounting functions find it a major challenge to calculate this figure to within a 10% margin of error. In both cases, managers have to rely on incomplete data that is neither internally nor externally audited at that point. This can often lead to businesses overestimating their liability for tax to avoid the risk of penalties, which can then result in overpayment of corporation tax that cannot then easily be reclaimed (see action 1) when the final figures have to be submitted within six months of the year end. Many businesses simply incur fines.

This is not about reducing the overall liability for corporation tax, paid provisionally, rather it is for operating realistic timescales for payment of the provisional tax part of a business' tax liability in a manner that encourages compliance and accuracy.

Therefore, the private sector requests that quarterly provisional tax payments periods should be extended from 14 to 30 days of the quarter to which they relate, with no penalties applied (as at present). In addition, the final provisional tax payment of 90% of the liabilities is made within 60 days of the year-end with the same penalties as at present.



## PERSONAL TAXATION

### Income Tax

It is recommended that the top rate on individuals should not exceed the general corporate tax rate, that is, 30%. In addition, the tax bands for individuals appear to discourage compliance and harm the fight against poverty in Malawi. Today, a taxpayer will become liable to tax when his or her annual income exceeds about \$320 per annum. The Millennium Development Goals define an international poverty line of \$1 per day, or \$365 per annum.

We would suggest that the threshold above which tax should become payable should be progressively increased to K240,000 per annum. This suggestion takes into account our calculation that the average wage earner in formal employment probably supports about five other people. He or she should thus be allowed to earn \$1 per day, for each of six people, before being liable to tax. At today's exchange rate, this equates to about K240,000 per annum. We suggest the following changes be considered:

Current:

From	To	Tax
0	36,000	0%
36,001	54,000	10%
54,001	72,000	20%
72,001	1,200,000	30%
Over	1,200,000	40%

Proposed:

From	To	Tax
0	240,000	0%
240,001	600,000	15%
600,001	1,200,000	25%
Over	1,200,000	30%

Such a transition would take time and would have impact on revenue (not necessarily negatively). This should be phased in over a period of time, by granting higher than inflation indexation of thresholds, particularly skewed to benefit low income earners. This would have several positive economic benefits. It would contribute significantly to fighting poverty and provide incomes likely to be spent on locally produced consumption items. It would also encourage employment of less skilled workers by reducing their effective cost to the business. It would also have significant political appeal.

At the higher ends, a marginal tax rate of 40% probably contributes to non-compliance. Whilst there may need to be some caution here in adjusting rates and thresholds, the current rate and threshold is too high.

### Employees of NGOs

Many NGOs, Projects and Donor Agencies extend their 'corporate' tax-free status to their national employees, either by not deducting PAYE or commonly by giving tax-free allowances in excess of those permitted. This is not appropriate and in addition creates an employment-cost advantage for the non-private sector over the private sector. Education of such organisations of their legal liabilities is necessary as is better enforcement for tax-exempt organisations. Both these steps would contribute to raising GoM revenues.

## INVESTMENT INCENTIVES

Presently, investment incentives are available pursuant to the Investment Promotion Act and the Export Processing Zone Acts. In addition, the Minister for Finance has the discretion to exempt any person or business from any tax or other payment under the Public Finance Management Act.

### **Export Promotion Zones**

Export Promotion Zones (EPZs) are viewed by the business community as an imperfect vehicle for investment incentives, for a variety of reasons. Currently, under section 8 of the Act, the Minister may declare a factory or area of land to be an EPZ. There is an Export Promotion Zones Appraisal Committee defined by the Act, which acts in an advisory capacity to the Minister. In light of delays in receiving Ministerial approval, it is recommended that the Committee itself have the final say in designating EPZs.

The Act provides for import duty relief, but does not allow domestic businesses to sell to EPZ businesses at a zero rate of surtax. The result of this is that EPZ businesses pay surtax, and claim refunds from the MRA. Delays mean that there is often a considerable waiting period to receive refunds. We suggest that the Surtax Act be amended to allow for sales to EPZ businesses to be made at a zero rate of surtax.

Finally, we would suggest that the tax rate for EPZ businesses be further reduced. Today corporate tax is charged either at 0% for five years or 15% for the life of the company. We would suggest further lowering the latter rate to 10%, to encourage investment by new businesses.

### **Public Finance Management Act**

The power available to the Minister of Finance to provide an exemption to any taxpayer for any purpose gives rise to much suspicion on the part of current and would-be investors about the fiscal regimes that domestic competitors are in fact facing.

This problem could easily be overcome if the Act were amended, so that the Minister could only exercise his power by notice in the Malawi Gazette. In this way, transparency would be introduced into what has been a murky area.

It is also noted that the continued demands on Ministers' time for assessing such matters is an inappropriate demand on busy Ministers, particularly in the case of the Minister of Finance.

If there is to be retention of such powers, it needs to be delegated to an appropriate body that will make a decision based on clear and transparent criteria.

## IMPORT DUTIES

### Importation of Capital goods and spare parts

In principle, many capital goods that represent the basic items for capital expenditure are exempt from duty or subject to duty of 5%. However, there are three related problems. First of all, spare parts for all these duty free items (machinery, irrigation equipment and other replacement capital items) are dutiable, thus discouraging routine maintenance and replacement. Secondly, although capital goods to manufacture export oriented goods are supposed to be imported duty free, in practice duty is charged and remitted on application, but after some delay and using the Finance Minister's discretion. The investor therefore has to make an application in advance and be able to secure a refund (see 1 above). This represents a serious impediment to doing business. Thirdly, surtax is charged on machinery and other capital goods yet it is reclaimable immediately, though not usually repaid promptly. Paying duty and surtax which is then reclaimed simply adds extra cost for the importer and the MRA to administer, the bulk of which falls on the business as they also have to carry the cashflow cost that is exacerbated due to the lack of prompt refunds.

None of this supports the building of the productive base of the economy from which revenues for GoM can be generated from PAYE and corporate taxes. It also discriminates against the small/medium businesses making small investments that it is not worth the cost of pursuing the refunds or which the small investors are not aware how to reclaim. In addition, these taxes hurt Malawi's tourism industries. For legitimate tour operators and car hire companies, an allowance should be made for the allowance of vehicles free of duties.

Therefore, the private sector requests:

- That duty on agreed categories of spare parts for productive revenue generating investments is reduced to zero (we understand that there are revenue implications at point of entry, but that there is a need to consider certain categories that increase productive output, jobs and forex as special cases, for example spare parts for irrigation equipment).
- That surtax on capital equipment and spare parts in certain agreed categories is removed to avoid the cost of administration for government and producer.
- All certified industrial capital goods must be imported duty free without the investor having to apply for remission.

### Pre-shipment inspection of goods

Pre-shipment inspection is based on an assumption that importers undervalue dutiable imports to evade duty that is due. Some importers do deliberately undervalue imports and these should be caught and prosecuted as appropriate. However, PSI is a very blunt and expensive instrument. The administration of the system has been poor by all the contractors used, with delays costing firms significant extra costs in direct (demurrage) and indirect ways (loss of production whilst waiting for equipment, materials etc.). Most other countries in the region have ceased to use PSI and Malawi must follow suit, especially given the location disadvantage it has and the need for efficient importing to minimise already high costs. Ideally PSI should be removed and MRA should operate an effective investigation and auditing system (spot checking high risk transactions and businesses). Unless it can be shown otherwise, there is no basis for levying import duty on a value element that does not constitute an actual "cost" nor require foreign exchange.

In the absence of its abolition, several changes are required. Firstly, MRA takes the higher of the invoiced amount or the PSI valuation. This is an inconsistent and unfair practice. Secondly, PSI is being required for goods that are not even dutiable. This makes no sense

and just benefits the PSI contractor. A more realistic application of PSI would both speed the process for more at risk transactions/users and improve the cost efficiency for Government and businesses.

### **Equal treatment**

A number of anomalies arise from importation of intermediate and finished goods, in ways that disadvantage local manufacturers of similar goods. The importation of wheat flour is a good example, where local production is subject to surtax whilst imported flour is not. This encourages imports and discourages local manufacturing and has resulted in the severe restriction of production compared say to Zambia, where wheat milling is thriving. There are many other anomalies.

Where intermediate or finished goods are imported there is a need to ensure that any surtax or duty exemptions do not disadvantage similar products produced in Malawi.

## SURTAX / VAT

### **Special consideration for small businesses**

The current threshold of K2 million would seem to require many very small businesses, who are unlikely to be significant taxpayers, to register for surtax. Complying with surtax collection is a significant administrative burden for small businesses. At K2 million, any business selling more than \$1,500 of goods per month would have to register. We suggest that the threshold for registration for surtax should be increased to K12 million. This could be done progressively to avoid significant impacts on revenue.

Small businesses should be given an option to submit surtax returns less frequently than on a monthly basis. Providing returns monthly is a significant administrative burden for small businesses. The move to a quarterly return basis would improve the efficiency of the system for the businesses and the MRA as it would avoid generating as many claims, reducing the administrative cost to Government and business alike.

It would also be more equitable to the taxpayers given the long delays in receiving refunds. It would be revenue-neutral as any overpayment creates a liability, which has to be repaid. It would impact on government cash flows within the quarter, but would more fairly share the burden of cash flow between private and public sectors.

All OECD countries (with the exception of Mexico and Finland) allow quarterly returns for businesses with low turnovers. We would suggest that quarterly returns for businesses with low turnover should be an option.

In addition, some small businesses should also be allowed to calculate their surtax liability on a cash, rather than on an accruals, basis. This would recognize the cash flow problems that non payment of liabilities poses in Malawi. Many OECD countries allow for cash basis of return (Australia, Austria, Germany, Mexico, New Zealand, Switzerland, and the United Kingdom).

### **Transportation**

In order to reduce operating costs of transportation (see above for notes on the high cost of transport in Malawi), it is recommended that domestic as well as international transport services should be zero-rated. The impact on the transport industry also needs to be considered as they need to be able to reclaim surtax on their inputs, otherwise this will compound the problem of already high transportation costs.

### **Primary producers**

Primary producers should be zero-rated and not exempted.

### **Real property**

We concur with the authors of a World Bank paper on taxation who note that:

- “The common practice is that residential buildings and rent are exempted, but office buildings are fully taxed. Exempting residential building and residential rent is commonly practiced on the basis of both technical and equity grounds. Technically, it is hard to impute rent values for owner occupation: extensive information and subjective valuation are required. But, if residential building is VAT-exempt,

residential rent also needs to be exempted to eliminate any discrimination against renting and in favour of owner occupation. The treatment of real estate sales is non-uniform across countries with a VAT, even within the EU. (Table 1, due to Conrad (1990), shows the practice in selected countries in the European Community.) Generally, resale of residential housing is VAT-exempt.”<sup>3</sup>

We would also propose that surtax not be chargeable on the resale of residential property or residential rent, which is very unusual and unfair.

### **Payment dates**

We note in the 2004/05 budget speech that there was an intention to change the surtax payment date from the 30th to the 25th of the month. We suggest that if there is merit in changing the date then it should not be earlier than the 28th of the month, to allow businesses adequate time to prepare their returns and due to the high cashflow burden that already falls on the businesses.

### **Allowance for bad debts**

Bad debts that are proven to be irrecoverable should be allowed, within a realistic period, say one year.

### **Deadline to lodge appeals**

Registrants should be allowed to lodge an appeal in respect of errors within six years rather than six months.

### **Irrecoverable inputs**

Not all legitimate expenditure by surtax registered businesses gives rise to input tax credits. Irrecoverable inputs currently include hotel accommodation, repairs to non commercial vehicles (pick-ups, vans), costs of security, etc. It is recommended that business costs of this and similar nature that are incurred in the production of taxable goods and services should be eligible for surtax relief. A proper review of the list of excluded items is required and these should be properly gazetted.

### **Taxpayers in regular credit situations**

A few companies in Malawi export almost all of their production. They thus regularly have are in credit with the MRA with regard to surtax. The very high cost of finance (interest rates are now “only” 20% per annum, but have been as high as 45% in recent months) and delays in refunds make these credits a significant charge on these companies profitability.

Many countries have special programs to deal with refunds to exporters. Clearly, these must be carefully designed to prevent fraud and abuse. We would suggest that such a program be implemented, available to those companies with an excellent record of tax compliance. Audits could be made to records and purchases periodically to allow the MRA to satisfy itself that all claimed credits are legitimate.

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<sup>3</sup><http://www1.worldbank.org/publicsector/tax/PracticalIssues/papers/Value%20added%20taxation/Value%20Added%20Taxation.doc>, p. 32

## REVENUE ENHANCING MEASURES

As we have explained in the introduction, we understand that the Government of Malawi has little scope for reducing its revenues in the 2005/06 budget. We have some specific suggestions which would help to boost revenues:

Departments such as Registrar General, Immigration and Road Traffic should be able to sustain their operations internally. Charges for services currently provided can be reviewed upwards to realistic levels as follows:

- business registration fees for non-corporate establishments (brief-case businesses) could be increased from K200 to K1,000 or more;
- filing fees of statutory documents with the Registrar General, could be increased from K10 to K200 per document;
- search fees at the Registrar General could be increased from K10 to K500 per document (It is understood that Department of Lands charge K500); and
- road licence fees for motor vehicles could be increased.

## APPENDIX 1: SUGGESTIONS BY SOCAM

SOCAM has additional suggestions which were not necessarily endorsed by the other business associations. These include group relief and taxation of non-resident.

### **Group Relief For Tax Losses**

Group relief should be introduced with the proviso that this should only be available to businesses where beneficial ownership of not less than 80%, is held by the same people.

### **Non-Residents Tax**

Tax should become due and payable when the amount that is subject to non-residents tax is paid to the non-resident taxpayer, (but NOT on re-capitalisation of the amount due to the non-resident, as an incentive to re-invest) provided that if the amount due remains unpaid at the next balance sheet date, tax will automatically become due and payable by the payer at the normal rates unless it can be shown that non-payment was unavoidable.

The current provision where tax becomes payable on accrual or crediting of the amount to the beneficiary's account is not investor friendly.