



# Foreign source income - taxing for all

**Repeal of foreign source income  
tax exemption**

29 October 2021

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KPMG in Malaysia

# Overview and Commentary



**Nicholas Crist**  
Executive Director  
Corporate Tax

## Key Message

“With effect from 1 January 2022, the foreign source income tax exemption enjoyed by many taxpayers will cease to apply.”

## Taxation of Foreign Source Income



In the 2022 Budget, the Minister of Finance has proposed that foreign source income is to be subject to tax on a Malaysian resident where it is received in Malaysia with effect from 1 January 2022. While this is a technical proposal, requiring a specific amendment to the Income Tax Act, 1967 it will affect a number of taxpayers and is therefore likely to provide the Government with additional revenue.

Under existing law, many Malaysian taxpayers benefit from a tax exemption granted for foreign source income. Put simply, taxpayers do not pay tax on income received in Malaysia which is sourced from outside Malaysia. It should, however, be noted that this exemption does not apply to banks, insurance companies, shipping companies or airlines. The tax savings available to Malaysian taxpayers through the foreign source income exemption, and the corresponding opportunity cost to the Ministry of Finance can be considerable.

In analysing income, there can be questions as to where the source of income is. In the case of active income, for instance professional services, one would typically start by looking at where the services are performed. For rental income, regard would be had to the country in which the income generating property is located. While for dividends, the tax residence of the payer company is usually determinative.

However, in the case of interest and royalties, which may be regarded as passive income, the location of the source may be more nebulous. In determining the source of interest, Malaysian and overseas courts have directed that attention be given to where the money is lent. This has the effect that where a Malaysian company lends to a related company tax resident outside Malaysia, the source of interest income is typically viewed also to be outside Malaysia. Consequently, for Malaysian tax purposes the interest income received by the Malaysian company is viewed to be foreign source and therefore tax exempt. A similar position can be taken in respect of royalty income. In some cases, this may result in what has been termed “double non-taxation”. That is the payer obtains a tax deduction for the interest or royalty expense while the Malaysian recipient is exempted from tax.

In recent years, “double non-taxation” has been viewed as a cause for concern. This was initially identified as an issue under the Organisation for Economic Co-operation and Development’s Base Erosion and Profit Shifting initiative. More recently as a result of foreign source interest being exempt from tax, Malaysia has found itself on an European Union ‘grey list’ of countries. No doubt the 2022 Budget proposal will go a long way to addressing the EU’s concerns.

Affected taxpayers, which would appear to include individuals as well as corporates, will need to consider a number of issues arising from this proposal including:

- The impact on their tax position particularly with regard to the payment of tax instalments as well as the extent to which a credit can be claimed for foreign taxes suffered.
- Where taxpayers have borrowings that have been used directly or indirectly to fund overseas investments, the ability to effectively offset the interest expense on those borrowings against income from the overseas investments, should be investigated.
- With affected foreign source income due to be taxable under this proposal, transfer pricing documentation to prove that amounts are arm’s length, will be increasingly important.
- The precise wording of the proposal to bring foreign source income within the charge to tax, will need to be reviewed when the Finance Bill is released. There may be transitional provisions which could, for instance, cover the treatment of accrued interest, dividends and royalties as well as clarifying when income will be viewed to be “received” in Malaysia.
- A number of Malaysia’s Double Taxation Agreements (“DTAs”) provide that interest and royalties shall be deemed to arise in the overseas country where the payer is tax resident. The clarification of how DTAs will interact with the proposed change to the domestic law, will be an important step.

Should you have any questions or require further clarification, please do not hesitate to email or contact any of our Executive Directors, Directors, Associate Directors or Managers whom you are accustomed to dealing with or who are responsible for the tax affairs of your organisation.

## Authors



**Tai Lai Kok**  
Executive Director  
Head of Tax and  
Head of Corporate Tax  
ltai1@kpmg.com.my



**Nicholas Crist**  
Executive Director  
Corporate Tax  
nicholasrist@kpmg.com.my



**Leow Yune Yune**  
Director  
Corporate Tax  
yleow@kpmg.com.my



**Jessica Yap**  
Assistant Tax Manager  
Corporate Tax  
jessicayap@kpmg.com.my



**Nor Shuhada Yusof**  
Tax Consultant  
Corporate Tax  
shuhadayusof@kpmg.com.my

# Contact Us

## Petaling Jaya Office

### Tai Lai Kok

Executive Director –  
Head of Tax and Head of Corporate Tax  
ltai1@kpmg.com.my  
+603 7721 7020

### Bob Kee

Executive Director – Head of Transfer Pricing  
bkee@kpmg.com.my  
+603 7721 7029

### Soh Lian Seng

Executive Director –  
Head of Tax Dispute Resolution  
lsoh@kpmg.com.my  
+603 7721 7019

### Long Yen Ping

Executive Director –  
Head of Global Mobility Services  
yenpinglong@kpmg.com.my  
+603 7721 7018

### Ng Sue Lynn

Executive Director – Head of Indirect Tax  
suelynng@kpmg.com.my  
+603 7721 7271

## Outstation Offices

### Penang Office

#### Evelyn Lee

Executive Director – Penang Tax  
evewflee@kpmg.com.my  
+604 238 2288 (ext. 312)

### Kota Kinabalu Office

#### Titus Tseu

Executive Director – Kota Kinabalu Tax  
titustseu@kpmg.com.my  
+6088 363 020 (ext. 2822)

### Ipoh Office

#### Crystal Chuah Yoke Chin

Tax Manager – Ipoh Tax  
ycchuah@kpmg.com.my  
+605 253 1188 (ext. 320)

### Kuching & Miri Offices

#### Regina Lau

Executive Director – Kuching Tax  
reglau@kpmg.com.my  
+6082 268 308 (ext. 2188)

### Johor Bahru Office

#### Ng Fie Lih

Executive Director – Johor Bahru Tax  
flng@kpmg.com.my  
+607 266 2213 (ext. 2514)

# KPMG Offices

## **Petaling Jaya**

Level 10, KPMG Tower,  
8, First Avenue, Bandar Utama,  
47800 Petaling Jaya, Selangor  
Tel: +603 7721 3388  
Fax: +603 7721 3399  
Email: [info@kpmg.com.my](mailto:info@kpmg.com.my)

## **Penang**

Level 18, Hunza Tower,  
163E, Jalan Kelawei,  
10250 Penang  
Tel: +604 238 2288  
Fax: +604 238 2222  
Email: [info@kpmg.com.my](mailto:info@kpmg.com.my)

## **Kuching**

Level 2, Lee Onn Building,  
Jalan Lapangan Terbang,  
93250 Kuching, Sarawak  
Tel: +6082 268 308  
Fax: +6082 530 669  
Email: [info@kpmg.com.my](mailto:info@kpmg.com.my)

## **Miri**

1st Floor, Lot 2045,  
Jalan MS 1/2,  
Marina Square, Marina Parkcity,  
98000 Miri, Sarawak  
Tel: +6085 321 912  
Fax: +6085 321 962  
Email: [info@kpmg.com.my](mailto:info@kpmg.com.my)

## **Kota Kinabalu**

Lot 3A.01 Level 3A,  
Plaza Shell,  
29, Jalan Tunku Abdul Rahman,  
88000 Kota Kinabalu, Sabah  
Tel: +6088 363 020  
Fax: +6088 363 022  
Email: [info@kpmg.com.my](mailto:info@kpmg.com.my)

## **Johor Bahru**

Level 3, CIMB Leadership Academy,  
No. 3, Jalan Medini Utara 1,  
Medini Iskandar,  
79200 Iskandar Puteri, Johor  
Tel: +607 266 2213  
Fax: +607 266 2214  
Email: [info@kpmg.com.my](mailto:info@kpmg.com.my)

## **Ipoh**

Level 17, Ipoh Tower,  
Jalan Dato' Seri Ahmad Said,  
30450 Ipoh, Perak  
Tel: +605 253 1188  
Fax: +605 255 8818  
Email: [info@kpmg.com.my](mailto:info@kpmg.com.my)

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