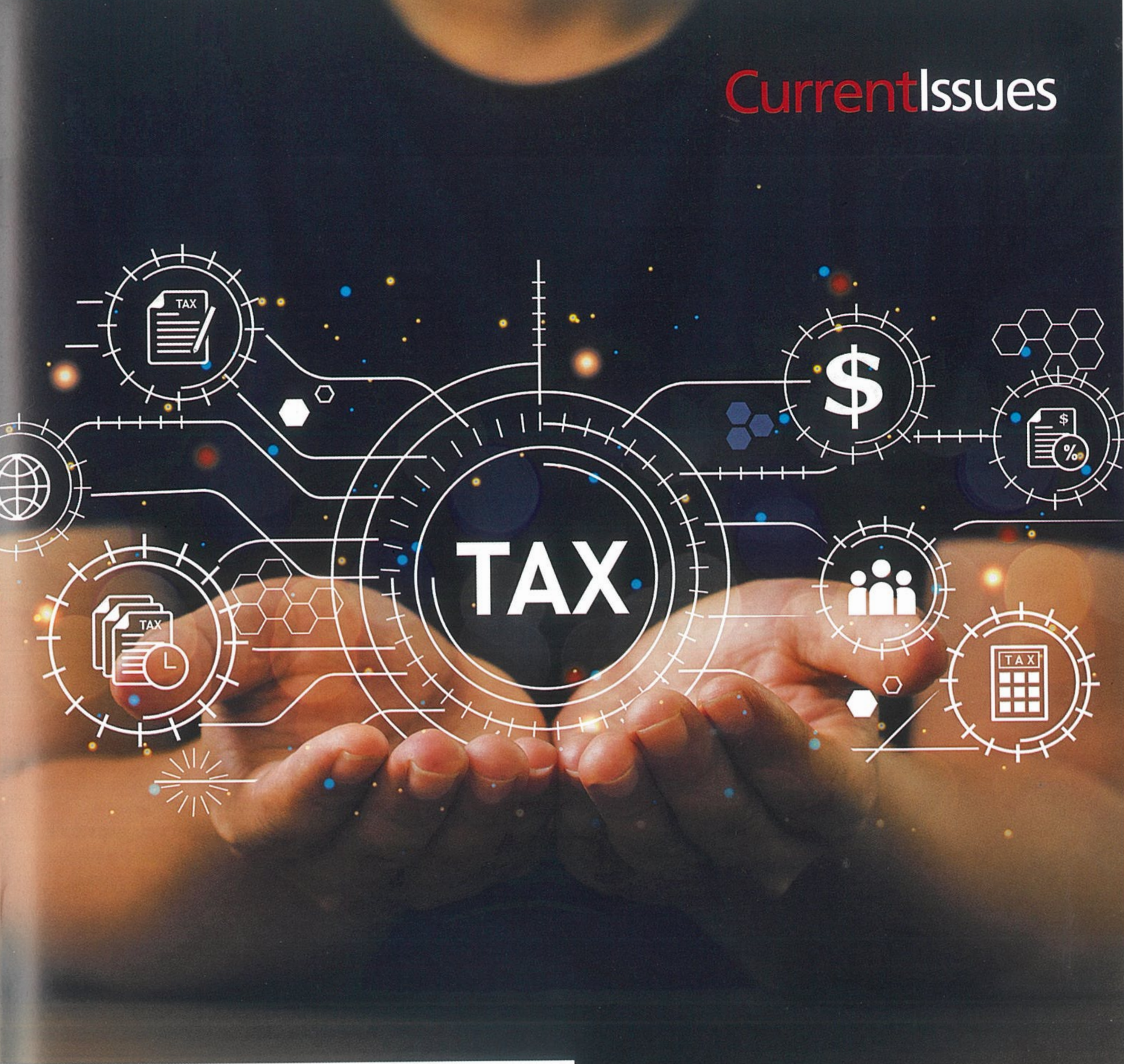

FOREIGN SOURCE INCOME

TAXING TIMES

Nicholas Anthony Crist

For many years Malaysian resident companies, individuals and unit trusts amongst others, have enjoyed a general tax exemption for foreign source income. However, as originally proposed in the 2022 Budget, this exemption will cease to apply with effect from 1 January 2022. This article seeks to examine the impact of the proposal to repeal the foreign source income exemption.

Shortly before this article went to print, the Ministry of Finance on 30 December 2021 announced that, subject to conditions, the following foreign source income received in Malaysia from 1 January 2022 to 31 December 2026, will remain exempt from Malaysian income tax.

Category of Resident Taxpayer	Foreign Source Income Exempted
Companies / Limited Liability Partnership	Dividend income
Individuals (other than those who carry on business through a partnership)	All classes of foreign source income

THE FOREIGN SOURCE INCOME EXEMPTION

The foreign source income exemption in Schedule 6, Paragraph 28 of the Income Tax Act ("ITA") up until 31 December 2021, provided:

> *"Income of any person, other than a resident company carrying on the business of banking, insurance, sea or air transportation, for the basis year for a year of assessment derived from sources outside Malaysia and received in Malaysia shall be exempted from income tax. The key to this exemption was whether income was "... derived from sources outside Malaysia."*

WHERE IS INCOME SOURCED

In practice the types of income to which the exemption would be relevant included rental from property, dividends, interest, royalties and services. To determine the location of an income source it is necessary to consider not only the provisions of the ITA but also case law and any relevant Double Taxation Agreement. A useful starting point is the following extract of the judgement of the UK's Privy Council in ***CIR v Hang Seng Bank Ltd* (1990)**, which was cited by the Malaysian High Court in ***KPHDN V Cardinal Health Malaysia Sdn Bhd* (2011)**:

"The broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the service was rendered or the profit-making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected."

CONSEQUENCES OF BEING EXEMPT

Aside from the obvious of not paying income tax, the exemption for foreign source income had a number of consequences, including:

1. Expenses attributable to foreign source income were effectively disallowed as a tax deduction as they would be restricted for offset against exempt income. A major cost would often be interest expense, where for example a company borrowed money to lend to an overseas company.

> **"Prior to Year of Assessment 2008, dividends were, under Section 108 ITA, required to be 'franked' using credits representing tax paid. However, in the case of foreign source income, dividends could be paid from an exempt account without the need for Section 108 credits. The exempt account in this instance could only be maintained by foreign source income which was received in Malaysia. Companies attempting to pay such dividends when insufficient foreign source income had been received in Malaysia would, in the absence of sufficient Section 108 credits, find themselves subject to hefty shortfall penalties."**

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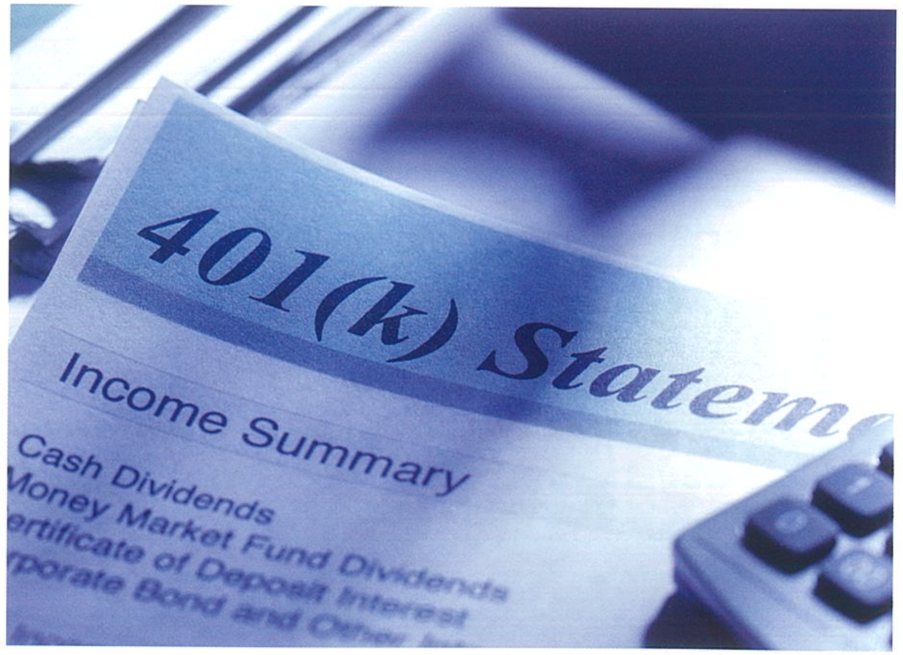
3. A particular concern was that the foreign source income exemption could result in a tax advantage where an expense would be tax deductible in the payer's country but would be exempt from tax in Malaysia. In recent years, "double non-taxation" has been viewed as a cause of concern. This was initially 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 the European Union's 'grey list' of countries. No doubt the 2022 Budget proposal will go a long way to addressing the EU's concerns.



foreign source income – taxing times

For banks, insurance companies as well as those in the shipping and air transportation business, foreign source income has remained taxable.

REPEAL OF EXEMPTION

Pursuant to the Finance Bill 2021, the foreign source income exemption in paragraph 28 of Schedule 6 is amended to apply only to:

> *"The income arising from sources outside Malaysia and received in Malaysia by any person who is not resident in Malaysia".*

This has the result that under the general charging provision in Section 3 ITA "... income of any person... received in Malaysia from outside Malaysia" would be subject to income tax. This change is effective from 1 January 2022.

It is understood that there are no plans to introduce 'grandfathering' provisions to exempt foreign source income accumulated outside Malaysia prior to 1 January 2022 but received in Malaysia thereafter. However, in an apparent quid pro quo, foreign source income received in Malaysia by 30 June 2022, will be taxed at a concessional rate of 3% on the gross. Subsequently, statutory income attributable to foreign source income will be taxed at standard rates.

CONSEQUENCES OF FOREIGN SOURCE INCOME BEING TAXED

Aside from the increase in revenue collection, there are a number of significant consequences to foreign source income being taxable, including:

(i) Tax deductions should be available for expenses incurred in the production of foreign source income. Of particular note interest expense on borrowings used to make loans to overseas group companies, would now prima facie qualify for a tax deduction in arriving at statutory income.
(ii) With foreign source income being taxable, transfer pricing documentation to support that related party transactions are at arms length, becomes more of a necessity than ever.
(iii) Whether foreign source income has been received in Malaysia.
(iv) The extent to which relief is available for foreign taxes suffered on that foreign income.

In the writer's view, items (iii) and (iv) above are particularly deserving of further consideration.

RECEIVED IN MALAYSIA

As foreign source income is only taxable when received in Malaysia, the timing of receipt may provide an area of dispute between taxpayers and the MIRB.

Foreign source income remitted into an account with a Malaysian bank is clearly received in Malaysia. More troubling, however, is the issue of constructive receipt. Simply put, a constructive receipt would involve monies located outside Malaysia being applied for the benefit of someone in Malaysia. As noted above, in the context of amounts being credited to an exempt account, the IRBM had previously rejected the notion of a constructive receipt as being an amount received in Malaysia.

As a comparison Singapore, which also taxes foreign source income on a received basis, has provided a statutory definition of "received". In this respect Section 10(25) of the Singapore ITA states:

"(25) It is hereby declared for the avoidance of doubt that the amounts described in the following paragraphs shall be income received in Singapore from outside Singapore whether or not the source from which the income is derived has ceased:

(a) any amount from any income derived from outside Singapore which is remitted to, transmitted or brought into, Singapore;
(b) any amount from any income derived from outside Singapore which is applied in or towards satisfaction of any debt incurred in respect of a trade or business carried on in Singapore; and
(c) any amount from any income derived from outside Singapore which is applied to purchase any movable property which is brought into Singapore."

The insertion of a similar provision in the ITA would be a welcome addition. In the meantime, it is worth noting that the IRBM has announced a Special Programme for Foreign Income Remittance which is aimed at amounts received in Malaysia in the period to 30 June 2022, to which the 3% rate of tax should apply. At the time of writing the full details of the Special Programme are not available. However, taxpayers will be required to submit a declaration to the IRBM in respect of the foreign income received in Malaysia.

RELIEF FOR FOREIGN TAXES

Taxpayers in receipt of foreign source income will need to consider the extent to which a credit can be claimed against Malaysian tax for any foreign taxes suffered on that income. The ITA offers taxpayers two options for claiming relief for foreign taxes namely:

1. unilateral credit, and
2. bilateral credit.

The choice of option is determined by reference to the country from which the foreign income is sourced. Where that country has a comprehensive Double Taxation Agreement ("DTA") with Malaysia, bilateral credit is available pursuant to the provisions of that DTA. The terms of the relief may vary from DTA to DTA. Where the country of source does not have a DTA with Malaysia, only unilateral credit is available.

UNILATERAL CREDIT

Where unilateral credit applies, the tax credit that can be claimed is limited to the lower of:

i. one half of the foreign tax payable on the foreign income for the year, and
ii. the Malaysian tax chargeable in respect of the foreign income.

This can be reflected in the following example:

EXAMPLE 1

In 2022, A Bhd receives interest income of US$1 million from B Inc. B Inc is tax resident in a country that does not have a DTA with Malaysia. When B Inc. pays interest to A Bhd, it deducts withholding tax (WHT) at 20%. B Inc. remits withholding tax (WHT) of US$200,000 to the tax authority in its country and pays the balance of US$800,000 to A Bhd. In addition to this interest, income A Bhd has statutory business income of RM50 million.

Unilateral credit is computed as follows.

The example assumes a RM:US$ exchange rate of 4:1.

Simplified Malaysian tax computation.

- RM4,000,000 (foreign source interest) + RM50,000,000 = RM54,000,000
- RM54,000,000 @ 24% = RM12,960,000

Unilateral Credit

i. Malaysian tax on foreign source income

$$\frac{\text{RM4,000,000}}{50{,}000{,}000 + 4{,}000{,}000} \times \text{RM12,960,000} = \text{RM960,000}$$

ii. Foreign tax - RM800,000 (ie. US$200,000 x 4)
Foreign tax @ 50% = RM800,000 x 50% = RM400,000

The unilateral tax credit is therefore limited to RM400,000.

For unilateral credit, foreign income means income derived from outside Malaysia.

BILATERAL CREDIT

Bilateral credit is more generous than the unilateral credit. The 50% limitation on the foreign taxes does not apply although the relief claimed cannot exceed the Malaysian tax on the foreign source income.

With reference therefore to Example 1 above, if B Inc. was tax resident in a DTA country the credit claimable in respect of foreign taxes would be the full withholding tax suffered, RM800,000, as this does not exceed the Malaysian tax payable on that income of RM960,000.

It should be noted that definition of 'foreign income' adopted for bilateral credit purposes, includes not only income derived from outside Malaysia (as for unilateral credit), but also income derived from Malaysia charged to foreign tax.

FOREIGN TAXES

In many cases the amount of the foreign tax is relatively easy to identify. In the case of rental from real property, some form of income/profits tax is likely to have been paid in the country where the land is situated. In the case of interest and royalties, WHT will often have been levied in the country of source. It is, however, in relation to dividends that the most complex calculations of foreign tax may be required.

To the extent that dividends are subject to WHT, this should be relatively easy to identify. However, where bilateral credit is available, the relevant DTA may, depending on wording, enable credit to be claimed for the underlying tax and this is where complexities can arise.

UNDERLYING TAX CREDIT

In the context of dividends, underlying tax credit essentially provides a credit for the overseas income/profit tax levied on the profits from which the non-resident

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company has paid the dividend. There is usually a requirement for the recipient shareholder to have a minimum shareholding in the overseas company. Article 24(2) of the UK/Malaysia DTA provides a suitable example:

"Where such income is a dividend paid by a company which is a resident of the United Kingdom to a company which is a resident of Malaysia and which owns not less than 10 per cent of the voting shares of the company paying the dividend, the credit shall take into account United Kingdom tax payable by that company in respect of its income out of which the dividend is paid. The credit shall not, however, exceed that part of the Malaysian tax, as computed before the credit is given, which is appropriate to such item of income."

A simple example helps to provide further context to the determination of underlying tax credit:

EXAMPLE 2:
UK Co is a wholly owned UK resident subsidiary of X Bhd.

UK Co makes pre-tax profit of £1,000,000, on which it pays UK corporation tax at 19%. Therefore, the profit after tax is:

£1,000,000 – 19% = £810,000

Computation of Underlying Tax	
	£
Net dividend paid to X Bhd	810,000
Gross up for UK tax on profits	190,000
Grossed up dividend	1,000,000
Malaysian Tax	
Dividend from UK Co (assumed exchange rate £1:RM5.5)	RM5,500,000
Malaysian tax on gross dividend (RM5,500,000 @ 24%)	RM1,320,000
Underlying tax credit* (£190,000 x 5.5)	(RM1,045,000)
Malaysian Tax payable (after foreign tax credit)	RM275,000

*Bilateral credit limited to lower of:

(i) foreign tax
(ii) Malaysian tax on that income

Complexities arise in the computation of underlying tax credit where there are a number of subsidiaries or associates which contribute to the dividends which is ultimately remitted to the home jurisdiction, in our case Malaysia.

Given the difficulties in calculating bilateral tax credit, one option would be to disregard dividends from companies resident in countries that have a similar tax rate to Malaysia or higher. The logic to such an exemption would be that given a similar or higher tax rate in the originating company, the underlying tax should in any event be sufficient to offset any Malaysian tax.

Hence, an automatic exemption would avoid unnecessary inconvenience for taxpayers.

Singapore has adopted an exemption system similar to that postulated above. In outline foreign source income received in Singapore may qualify for an exemption where the following conditions are met:

i. the headline tax rate of the foreign jurisdiction from which the income is received is at least 15%, and

ii. the relevant foreign income has been subject to tax in the foreign jurisdiction from which it was received.

An alternative route but of more limited scope, would be to consider granting a "participation exemption" in respect of dividend income where certain minimum shareholding requirements are met. The participation exemption has been a feature of the Dutch tax system for many years and has subsequently been adopted by a number of other countries.

In view of the foregoing, the MoF's announcement on 30 December 2021, to extend the foreign source income exemption for dividends up to 31 December 2026, is welcome. As dividends are invariably not deductible in computing the taxable profits of the payer company, issues of double non taxation should not arise.

CONCLUDING REMARKS
The proposed repeal of the foreign source income tax exemption is arguably one of the most notable features of the 2022 Budget. The repeal can be explained, in part, as a response to pressure from the European Union. Further, the repeal taken with the proposed Special Programme For Foreign Remittance and the declaration that will need to be made for remittances in the first six months of 2022, should enable the MIRB to achieve a greater degree of taxpayer compliance.

However, in contrast Hong Kong and Singapore appear able to retain their existing exemptions for foreign source income and this may be to Malaysia's disadvantage. This would be compounded where foreign source income from all sources is taxable, given the challenge of computing credit for foreign taxes particularly in the case of dividends.

The MoF's announcement on 30 December 2021 to continue the foreign source income exemption for individuals and for companies and limited liability partnerships in respect of foreign dividends, is clearly good news. However, it should be noted that this continuation is time limited until 31 December 2026.

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