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Taxing foreign-sourced income: A step too far?

STORIES BY **ESTHER LEE** AND **SUPRIYA SURENDRAN**

Budget 2022's proposal for Malaysia to withdraw the tax exemption on foreign-sourced income has caused a stir among companies and individuals with significant investments abroad.

From Jan 1, 2022, the tax exemption on foreign-sourced income received in Malaysia under Paragraph 28, Schedule 6 of the Income Tax Act (ITA) 1967, will be withdrawn, meaning that foreign-sourced income — whether from business or employment or in the form of dividend, royalties, interest or rental — remitted into the country will be subject to Malaysian tax.

The exemption, says EY Asean tax leader and tax managing partner Amarjeet Singh, has been in place since 1998 for companies and since 2004 for individuals, in a bid to encourage remittance of such income.

"It was one of the measures to deal with the 1997/98 Asian financial crisis. Prior to these years, remittance of foreign-sourced income was taxed in Malaysia," recalls Amarjeet.

It is no wonder, then, that companies that have invested significantly abroad ever since the exemption was in place are now scrambling to assess the implications of this measure on their tax position and businesses.

"Removing the FSIE effectively reduces the ability of, and attractiveness to, the private sector to reinvest in Malaysia or use the country as a base from which to run their global operations." — Amarjeet

"Computation of unilateral or bilateral credit could be complicated while transfer pricing documentation to prove that transactions are made at arm's length will be increasingly important." — Crist

What seems to be of utmost concern for such companies is the dividends they receive, as dividends are one of the means by which profits from overseas investments are remitted back to headquarters.

Dividends are paid out of net profit, and net profit would have already been taxed under the corporate income tax rate imposed by the foreign country.

"Many of these businesses have structured their global investments based on the assumption that profits will not be subject to potential double taxation. Given the broad change that is proposed, these structures could lead to dividends being subject to additional taxes, hence reducing their returns," says PwC Malaysia tax leader Jagdev Singh.

"It is sometimes not easy to change these structures overnight. Businesses thrive on certainty in tax regulations, and the introduction of such a major change without prior engagement has caused alarm in many sectors."

Individuals are not spared too. According to KPMG Malaysia corporate tax executive director Nicholas Crist, those who have investments abroad and have been receiving foreign-sourced dividends, interest income and rental or who have made gains on the disposal of properties overseas over the years may now find it challenging to segregate the nature of their remittance to Malaysia.

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One question that many have raised is: What compelled the government to withdraw the foreign-sourced income exemption (FSIE)?

The obvious answer, according to the 2022 Budget speech, would be to ensure that Malaysia complies with international standards in the aspect of "foreign harmful tax practices".

To recap, on Oct 5, the European Union (EU) put Malaysia on its "grey list" of non-cooperative jurisdictions for tax purposes. What that means is that Malaysia was identified by the EU as a tax jurisdiction that has a "harmful" foreign-sourced income exemption, but it has committed to amending or abolishing this regime by making necessary legislative changes to remove or amend the harmful features by Dec 31, 2022.

Malaysia is not alone, as other jurisdictions such as Hong Kong, Costa Rica, Qatar and Uruguay are also on the list.

It is important to note, however, that the EU does not consider FSIE regimes, or regimes that charge corporate tax on a territorial basis, as problematic in themselves, tax consultants point out.

"Based on the EU's guidance, FSIE regimes that apply on a territorial basis are not inherently problematic. The EU is concerned, however, about where such regimes create situations of double non-taxation. In particular, they are concerned with the non-taxation of passive income in the form of interest or royalties, where the income recipient has no substantial economic activity," says Deloitte Malaysia tax leader Sim Kwang Gek.

If the intention was for the country to comply with international best practices, there could have been other ways to address the situation instead of a blanket withdrawal of the FSIE regime.

"Why was there a need to rush this?" asks Dr Veerinderjeet Singh, the non-executive chairman of Tricor Malaysia. "We have until December 2022 to come up with a solution."

Amarjeet believes that if the sole objective of the proposal for the FSIE withdrawal was to have Malaysia removed from the EU's "grey list", the country could have achieved it by putting in place certain conditions or safeguards to the FSIE.

He says: "Hong Kong, which is in a similar predicament as Malaysia, has indicated that it will continue to adopt the FSIE and is likely to introduce certain minimum substance criteria in order for companies to enjoy tax exemptions on foreign-sourced income. Meanwhile, the FSIE for individuals is likely to remain completely unchanged."

PwC's Jagdev adds that Malaysia has several options to consider, as most countries worldwide offer some form of foreign income tax exemption.

"One is to exclude active business income from the scope of the FSIE removal. In fact, as Malaysia has committed to implementing Pillar 2 of the Base Erosion and Profit Shifting (BEPS) Plan, Malaysian-headquartered corporates with revenues of €750 million or more would be subject to a global minimum tax rate of 15%, with Malaysia being entitled to collect any shortfalls," he says.

Jagdev adds that Malaysia could also consider taxing passive income, but introduce certain criteria for exemptions to encourage remittance back for domestic investment.

"Most countries apply a shareholding participation exemption, whereby remittance by subsidiaries in which the Malaysian shareholder has a certain minimum shareholding (certain countries have participation requirements as low as 5%) are exempted from tax," he elaborates.

Another country mentioned by tax consultants that is not on the EU's grey list but has an acceptable FSIE regime is Singapore, where there are minimum criteria to be met for exemption.

Padding up coffers but with far-reaching implications

The proposed change leaves no doubt that Malaysia has addressed the EU's concerns about any potential "foreign harmful tax practices".

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How Singapore applies its foreign-sourced income exemption

Many have urged the government to take a further look at Singapore's foreign-sourced income exemption (FSIE) regime in the light of the proposed change to Malaysia's FSIE regime that is set to take effect on Jan 1, 2022.

It is for good reason, given how Singapore's FSIE regime has stayed out of the EU's "grey list" of countries with harmful tax practices, and continues to provide exemption on foreign-sourced income for businesses and individuals subject to the meeting of certain criteria.

Singapore's Income Tax Act clearly spells out categories of foreign-sourced income entitled to exemption.

Specified foreign income received in Singapore on or after June 1, 2003, by specified resident taxpayers will be exempt from tax where the qualifying conditions are met.

The following is a brief overview of how Singapore applies its FSIE regime.

What constitutes foreign-sourced income?	Foreign income that does not arise from a trade or business carried on in Singapore
Who does it apply to?	All Singapore tax resident persons receiving foreign-sourced income in Singapore
Exemptions available?	Yes, specified foreign income received in Singapore by specified resident taxpayers from June 1, 2003, are exempt from tax.
What is the specified foreign income?	• Foreign-sourced dividend; • Foreign branch profits; and • Foreign-sourced service income.
What are the qualifying conditions for exemption?	• 'Subject to tax' condition (the specified foreign income must have been subject to tax in the foreign country from which the income is received); • 'Foreign headline tax rate of at least 15%' condition (the highest corporate tax rate of the foreign country of source in the year the specified foreign income is received in Singapore must be at least 15%; the headline tax rate need not be the actual tax rate imposed on the specified foreign income in that country); and • 'Beneficial tax exemption' condition (Comptroller of Income Tax must be satisfied that the tax exemption would be beneficial to the specified resident taxpayers).
What about resident individuals?	All foreign-sourced income received in Singapore by resident individuals, except those received through a Singapore partnership, will be exempt from tax where the Comptroller is satisfied that the exemption will be beneficial to them

INLAND REVENUE AUTHORITY OF SINGAPORE

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How the FSIE withdrawal might affect you

As announced in Budget 2022, the proposal to remove tax exemption on income derived from foreign sources (withdrawal of foreign- sourced income exemption, or FSIE) and received in Malaysia by Malaysian tax residents under Paragraph 28, Schedule 6, of the Income Tax Act 1967 will come into effect on Jan 1, 2022.

Under a Special Remittance Programme announced by the Inland Revenue Board, a tax rate of 3% will be imposed on foreign-sourced income brought in by a tax resident from Jan 1 to June 30 next year, and all income will be accepted in good faith without any review or investigation conducted by the authority. Any income brought in from July 1, 2022, would be subject to the prevailing tax rate.

For clarity, an individual who is in Malaysia for a period of 182 days or more in a calendar year is generally categorised as a tax resident, whereas a company is defined as a tax resident in Malaysia if the management and control of its business is in the country.

Here are some scenarios involving foreign-sourced income. *The Edge* asks tax experts to weigh in on these examples.

Scenario 1:

A Malaysian company that is a tax resident earns dividend income from its subsidiary in Singapore and remits that income to Malaysia, or a Malaysian individual who is a tax resident brings back dividend income earned from shares held in Singapore.

Subject to Malaysian tax with effect from Jan 1, 2022: YES

Tricor Services (Malaysia) Sdn Bhd non-executive chairman Dr Veerinderjeet Singh: In Singapore, similar to Malaysia, the dividends paid are subject to the single-tier system and therefore no tax is imposed on the dividends credited to shareholders.

With the proposed provision, the company will be subject to tax in Malaysia once it brings in that dividend income into the country, and it looks like it will not receive any tax credit on the dividend as the dividend has not suffered any tax in Singapore. Therefore, for companies, a tax rate of 24% is expected to be imposed on the dividend income brought in (assuming that it is brought in after the Special Remittance Programme period is over).

For corporates, as these dividends are paid out from the retained earnings of the Singaporean subsidiary, a corporate tax has already been paid in Singapore. So, the argument here is why would the Malaysian corporate need to pay tax again here, as corporate tax has already been paid by its subsidiary in Singapore.

However, if you are a Malaysian company with a subsidiary in Indonesia, a withholding tax is imposed on dividends paid out. So, when the Malaysian company remits that dividend income to Malaysia, it will be taxed here and a credit for the Indonesian withholding tax suffered will be claimed against the Malaysian tax imposed on the dividend income, and only the differential is paid.

Another aspect that needs to be considered is double taxation agreements, which may impact the taxability of the income brought in.

As for Malaysian individuals, they would be taxed on dividend income brought in, but the rates will follow the existing personal tax rates applicable to individuals. So, foreign dividend income will be added to all other income and the relevant personal tax rate will be applied.

As for non-residents that bring in dividend income, they will not be taxed on such foreign income as non-residents are exempted from the proposed provision.

Scenario 2:

A Malaysian company that is a tax resident earns interest income from bonds or fixed deposits held overseas and remits that income to Malaysia, or a Malaysian individual who is a tax resident earns interest income from bonds or fixed deposits held overseas and remits that income to Malaysia.

Subject to Malaysian tax with effect from Jan 1, 2022: YES

Veerinderjeet: Assuming that the interest income earned is subject to a withholding tax overseas, and now with the proposed provision, once the interest income is brought here, it will also be taxed. However, the taxpayer should be able to claim a credit for the tax suffered in the foreign country. But all documentation pertaining to that interest income needs to be kept. And this is a problem because prior to this proposed provision coming into force, no one would strictly maintain such documentation on interest income as it was not required before. As for the withholding tax imposed overseas that is normally automatically deducted, in most cases, you may not get a receipt as evidence of the deduction of tax paid overseas. So now with this proposed provision, taxpayers would need to exercise more diligence in obtaining these documents.

As for Malaysian individuals, they would also be taxed on the interest income brought in, but the rates will follow the existing personal tax rates. So, foreign interest income will be added to all other income and the relevant personal tax rates will apply.

Baker Tilly Malaysia managing partner and Asia-Pacific leader for tax services Anand Chelliah: Generally, such interest income received by individuals from placement in a fixed deposit in Malaysia is not taxable as a concession. However, similar foreign-sourced interest income would be brought to tax under the proposed amendments. In the Budget 2022 appendices, it was mentioned that the proposal to impose tax on Malaysian residents on foreign-sourced income received in Malaysia is to provide equitable tax treatment with the income accrued in Malaysia or derived from Malaysia. There is a perceived inconsistency on this equitable tax treatment in respect of the above.

Scenario 3:

A Malaysian tax resident living in Johor Baru and working in Singapore who remits his employment income earned in Singapore to Malaysia.

Subject to Malaysian tax with effect from Jan 1, 2022: YES

Veerinderjeet: In this case, the person will pay tax on employment income in Singapore. And because this person is staying in Malaysia, he will be a tax resident here as he will bring in the income earned in Singapore to Malaysia. Currently, he does not pay tax on his employment income from Singapore in Malaysia as he has paid tax in Singapore. But under the proposed provision, such income will be taxed by the authorities here when he brings the income back.

So now, the person would need to prove that tax was suffered in Singapore to be eligible to claim a tax credit against the Malaysian tax imposed, and that will involve more paperwork. And there is also the possibility that not all of his employment income will be brought into Malaysia — some of it might still be kept in Singapore, so Malaysia will only impose income tax on the portion of the income that was brought in. The tax credit would be only for that portion of the income brought into Malaysia.

Baker Tilly Malaysia director of tax services (technical) Murugan Anbanantham: For employment income that is earned in Malaysia, an individual pays tax on the income received and may have built up savings for the future. Such savings on which tax had already been paid previously will not be subject to future tax when withdrawals are made from such savings in Malaysia.

However, an employee who works overseas and has saved his or her employment income in foreign banks may now be worried if such savings withdrawn from foreign banks and remitted to Malaysia will be subject to tax. Also, the savings may have earned interest — again the issue of interest income for individuals being taxed on remittance back to Malaysia.

For Malaysian employees, their withdrawals from the Employees Provident Funds are obviously not taxable. However, such employees who may have worked overseas and contributed to a similar pension fund overseas may find themselves being questioned if and when they were to remit such funds back to Malaysia — let's say, if they are planning to return to Malaysia after many years working overseas. There must be clear rules in place to alleviate such concerns on the part of such persons.

Scenario 4:

A Malaysian company that is a tax resident earns rental income from properties held overseas and remits that income to Malaysia, or a Malaysian individual who is a tax resident earns rental income from a property held overseas and remits that income to Malaysia.

Subject to Malaysian tax with effect from Jan 1, 2022: YES

Veerinderjeet: Rental income is taxable, and if there is any foreign tax suffered overseas, a double tax credit can be claimed against the Malaysian tax imposed. A double tax credit, also called a bilateral credit, applies to countries with which Malaysia has a double tax agreement. For countries with which Malaysia does not have a double tax agreement, a

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double tax credit called a unilateral credit can be claimed. But this would be up to only half of the foreign tax suffered.

Other possible issues

Another issue, says Veerinderjeet, would pertain to the definition of the word "remitted" and the possibility that certain foreign income is deemed to be remitted in Malaysia even though funds were not brought in. This is mostly seen in contra transactions between related companies.

"For example, foreign dividend income declared by a Singapore subsidiary which is due to a Malaysian resident company is offset against certain amounts due from the Malaysian resident company to the Singapore subsidiary.

"In the usual context, such offsets will result in the foreign dividend income being deemed to have been remitted to Malaysia and so, would be taxable in Malaysia under the proposed provision. All these aspects will need to be looked into and will create more compliance requirements as well as increase compliance costs," says Veerinderjeet.

TraTax Tax Controversy partner Renganathan Kannan says the earnings of Malaysian companies and entrepreneurs are subject to tax on all income from businesses operated, managed and controlled in or from Malaysia — even if such income is paid by a foreign customer and the income is retained in a foreign bank account.

"Such income [would be taken as] Malaysian income and not foreign income, but businesses that have not paid Malaysian tax on such income are given an opportunity to remit the funds to Malaysia between January and June 2022 and may only get charged a 3% — instead of the prevailing — tax rate," he adds.

"The tax authority clarified earlier this week that no audit, investigation or penalty would be imposed on amounts remitted between January and June 2022. Hence, the 3% tax appears to be final. But it has to be kept in mind that Malaysian-derived income during or after [the year of assessment] 2021 does not qualify for this treatment."

Renganathan says for taxpayers who actively manage funds overseas, careful documentation is vital to analyse the capital and revenue nature of the funds retained after July 1, 2022, as the tax authority has expressed such amounts would be scrutinised to ensure no Malaysian-sourced income is retained therein without payment of tax.

Baker Tilly's Anand says guidance is needed for taxpayers in differentiating between revenue and capital gains as income tax in Malaysia goes on the premise that only revenue gains are taxed while capital gains are not taxable.

"As such, guidance is also needed by taxpayers in the manner of recognising what is revenue and capital gains when it comes to foreign-sourced income when such gains are repatriated. What is capital gains in Malaysia may be taxed as income in another country.

"Also, the relief provisions in our tax laws are aimed at relieving a person from suffering tax twice on the same income. Under such circumstances, there is an avenue to claim bilateral or unilateral relief. However, it may be a difficult task to ascertain the tax paid in the foreign country if such foreign taxes were paid in the past, and taxpayers would need to ensure that the related documents are kept and capable of substantiating the case for bilateral or unilateral tax relief. This is certainly burdensome."

Baker Tilly's Murugan says there is also the issue of deductibility of expenses on the foreign-sourced income that is repatriated back to Malaysia once the 3% on gross remittance period is over. Securing the tax deductions is going to be an arduous task ahead. "This may cause anxiety going forward," he adds. ■

Stability and visibility crucial for businesses

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Yet, it effectively changes Malaysia's tax system from a territorial tax system into a worldwide tax system by taxing all foreign income earned by Malaysian tax residents upon remittance.

Most likely, it would yield much-needed additional revenue for the country, given the strained financial position it is in.

Notably, the Ministry of Finance estimates that RM1.2 billion in revenue can be collected by taxing foreign-sourced income in 2022.

It is also worth highlighting that the Inland Revenue Board (IRB) recently said it was offering a Special Income Remittance Programme (PKPP) to residents in Malaysia who have income kept abroad, which will run from Jan 1 to June 30, 2022.

During these six months, the Finance Bill 2021 proposed that the concessionary rate of 3% tax would be imposed on foreign-sourced income remitted. IRB added that it would not carry out an audit review or investigation nor impose a penalty on income brought in during this period, but would accept it in good faith.

Aside from this, there has been no further guidance from IRB on whether there will be any exemption given on foreign-sourced income.

What are the implications from such a major change in the tax system?

One likely impact is that companies will retain more of their earnings abroad for reinvestment, says Lee Heng Guie, executive director of the Associated Chinese Chambers of Commerce and Industry of Malaysia's Socio-economic Research Centre.

This would mean that less investment income will be remitted back home, he adds.

Balance of Payments data shows that corporates have repatriated an annual average of RM27.8 billion in investment income — from both direct and portfolio investment — back to Malaysia between 2010 and 2020, compared with RM7.5 billion the decade before.

"We need to recognise that Malaysia is at a stage where it has to enhance its reliance on private sector investments and reduce reliance on public sector investments. Removing the FSIE effectively reduces the ability of, and attractiveness to, the private sector to reinvest in Malaysia or use the country as a base from which to run their global operations," says Amarjeet.

Compared with other countries in Asean, Jagdev says, Malaysia faces the existing challenge where the headline tax rate has stayed at 24% whereas many neighbouring countries have been lowering their corporate tax rates to 20%.

"With this change, it certainly would weigh negatively as investors look for an alternative location for their investments. Countries in the region, such as Singapore, Thailand and Indonesia, also provide exemption of foreign-sourced dividend income, subject to conditions such as minimum shareholding participation — where it is 10% in Singapore and 25% in Thailand — and the dividend being subject to a minimum tax, for example, 15%, in the source country, or reinvestment requirements," he explains.

Deloitte's Sim shares similar sentiments, adding that Malaysia may be less attractive as a location for businesses to

"One likely impact is that companies will retain more of their earnings abroad for reinvestment. This would mean that less investment income will be remitted back home." — Lee

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set up their holding company to house their overseas companies.

Malaysia should take guidance from what Singapore is doing, she says, considering that the city-state is not on the EU's grey list, yet exempts certain foreign-sourced income, albeit with conditions.

The Indonesian government recently amended the country's tax laws to allow tax exemptions for foreign-sourced income remitted to the country. A taxpayer that reinvests part of its dividend income in qualifying Indonesian assets would be given an exemption.

Meanwhile, for institutional investors such as the Employees Provident Fund, Permodalan Nasional Bhd and other fund management companies that have invested in foreign asset classes and are expected to remit most of their foreign-sourced income as part of the distribution of dividends to their investors, investment returns may be affected.

Among the challenges that could crop up next year, says KPMG's Crist, is how foreign-sourced income "received in" Malaysia would be defined.

"Would this include constructive receipt or deemed receipt? There is no clarification on the definition at this juncture," he says.

Crist adds that the computation of unilateral or bilateral credit could be complicated while transfer pricing documentation to prove that transactions are made at arm's length will be increasingly important.

Less explicit but equally detrimental is how existing and potential investors view the country. Stability and visibility are crucial for businesses.

Tricor's Veerinderjeet says: "The withdrawal may be viewed by investors as suggesting a trend of uncertainty and frequent changes in the Malaysian tax system. Perceived lack of stability alone can sway investment decisions.

"The withdrawal may also lead to perceptions that Malaysia is moving away from a tax system which has proven itself to be stable and reliable — a tax system that has been able to develop and sustain the country through difficult times."

Easy fix, but tax reforms necessary

Veerinderjeet believes the change in FSIE has been rushed. Without a mid-term plan announced on future changes envisaged for the tax system, investors will have a hard time visualising the planned changes to the tax system.

"If there is a mid-term plan available, investors can visualise the planned changes to the tax system and would not be made to bear the consequences of changes introduced annually with no clear rationale or basis other than supposed revenue-generation," he says.

While it is perfectly acceptable to look at measures to increase government revenue, says Jagdev, any potential situation that could lead to double taxation is perceived to be unfair.

"A holistic approach would be key in ensuring equitable treatment for businesses. The FSIE is a fundamental change in our tax system that has far-reaching effects for both corporates and the rakyat, unlike the Cukai Makmur, which is a one-off measure," he adds.

Amarjeet believes a mid- to long-term approach with the ultimate aim of generating sustainable increase in tax revenue would have been preferred.

"We can better achieve this through digitalising the tax administration system such that tax leakages from the shadow economy are reduced and, possibly, when the economy is more stable, implementing a broad-based consumption tax," he says.

It would be a great loss for Malaysia if the withdrawal of the FSIE fails to generate the expected amount of revenue, with less foreign income being remitted, but instead causes the country to lose out on domestic reinvestments and economic activity. ■