Cover Story

Taxing foreign-sourced income: A step too far?

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on foreign-sourced income received in Malaysia under Paragraph 28, Schedule 6 of the Income Tax Act (ITA) 1967, will be withdrawn, meaning that foreign-sourced income — whether from business or employment or in the form of dividend, royalties, interest or rental — remitted into the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 FTI’s 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 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.
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.

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<td>• “Beneficial tax exemption’ condition (Comptroller of Income Tax must be satisfied that the tax exemption would be beneficial to the specified resident taxpayers).</td>
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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.

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How the FSIE withdrawal might affect you

As announced in Budget 2022, the proposed tax on income derived from foreign sources (withdrawal of foreign-sourced income exemption, or FSIE) and received in Malaysia by non-resident tax residents under Paragraph 28, Schedule 6, of the Income Tax Act 1967 will come into effect on January 1, 2022, and 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 Singapore, 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 the dividends paid, 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 the income is transferred to the company, and it looks likely it will not receive any tax credit on the dividend as the dividend has not received any tax in Singapore. However, for companies, a tax rate of 24% is expected to be imposed on the dividend income brought in (assuming that 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 Singapore subsidiary, a corporate tax has already been paid in Singapore. So, the argument here is that in the 1990s, the Malaysia corporate tax rate was 24%, and the tax paid is already 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.

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 withholding tax overseas, and now with the proposed provision, even if the interest income is earned here, it will also be taxed. However, the taxpayer should aim to remit 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 applicable to individuals. So, foreign-sourced 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-sourced income as non-residents are exempted from the proposed provision.

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 living 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 paid and that it 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 the Malaysian tax will only impose income tax on the portion of the income that was brought in. The tax credit will be only for that portion of the income brought into Malaysia.

Baker Tilly Malaysia director of tax services (technical) Murugan Anbanathan: 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 has overseas savings and has saved his or her employment income in foreign banks may now be required to file a tax return on 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 Employee Provident Fund overheads are obviously not taxable. However, such employees who may have worked overseas and contributed to a similar pension fund overheads may find themselves being questioned if and when their funds are remitted back to Malaysia — let’s say, if they are planning to return to Malaysia after many years working over credits to shareholders.

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
Stability and visibility crucial for businesses

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Yet, it effectively changes Malaysia's tax treatment from the territorial tax system to 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 Finance Bill 2022 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 (PIRIP) 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 2023 proposed is the concessionary tax rate of 3% 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 the briefing at the Inland Revenue Board, 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. This would mean that less investment income will be remitted back home. — Lee

Based on the EU’s guidance, FISI regimes that are on a territorial basis are not inherently problematic. The EU is concerned, however, about where such regimes create situations of double non-taxation. — Sim

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Stability and visibility crucial for businesses

Malaysia should take guidance from what Singapore is doing, 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 who 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 RPMG’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.

Trion’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 perennial uncertainty, he adds.