

The path forward for Malaysia's foreign income exemption

Time flies. It will soon be the fourth anniversary of the government's move to narrow the broad-based tax exemption on foreign-sourced income received in Malaysia — a move which, since Jan 1, 2022, resulted in resident taxpayers (excluding corporates in certain industries) being taxed on such income when received back home.

Bold as it may have been, it was a necessary measure in response to Malaysia's then inclusion into the European Union's tax "Grey List", which comprises countries that have committed to certain tax reforms within an agreed timeline. This included Hong Kong, one of the world's premier global financial centres, which also implemented changes to its foreign-sourced income exemption taxation system.

Resident companies were elated when an exemption order was gazetted not long after to exempt foreign dividends received in Malaysia, while resident individuals were effectively exempted on all foreign income. A similar exemption order was introduced for certain foreign capital gains received in Malaysia by resident companies after the capital gains tax was introduced in 2024.

Conditions were attached to these exemption orders in line with international standards. For example, the foreign-sourced dividend exemption is contingent upon it being subjected to tax in the foreign country where the headline tax rate is at least 15% or based on compliance with economic substance requirements (ESR) in Malaysia. ESR is also a condition to enjoy the foreign capital gains exemption. Tax practitioners and taxpayers will surely remember the discourse that took place resulting from these exemption orders as they looked for clarity on these new rules. The government must be credited for acting swiftly by publishing guidelines to assist the business community.



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Navigating the road ahead

However, it is timely for corporates with foreign investments to remember that these exemptions will be expiring at the end of 2026. An extension, or at least some directional indication from the government in the upcoming Budget 2026, will be much welcomed by businesses which are either enjoying or intending to enjoy these exemptions.

While it is understandable if the government intends to maintain its policy of not granting tax exemptions indefinitely to facilitate periodic reviews for alignment with international developments, businesses would surely be appreciative if any extension of these exemption orders were given for a longer period instead.

A five-year horizon could be perceived as relatively short in the business world be-



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cause the holding period for foreign investments is generally much longer, especially capital-intensive ones. A longer exemption period would provide certainty and predictability — elements crucial for companies to make strategic investment decisions.

As a start, these exemption orders could be aligned with the foreign-sourced income exemption for individuals, which was supposed to expire on Dec 31, 2026, but was extended to Dec 31, 2036, not too long ago.

An extension of these exemption orders should also prevent any perceived regression of Malaysia's growing allure as an outbound holding company jurisdiction relative to more established countries such as Singapore and Hong Kong, which do not have any expiry to their foreign-sourced income exemption regimes.

There is also a disparity between the exemption orders currently. While both apply to resident companies only, foreign-incorporated companies (except those registered with the Companies Commission of Malaysia) are precluded from the exemption on foreign-sourced dividends received in Malaysia, even though they are Malaysian tax residents. This does not appear to be so for the exemption on foreign capital gains. Perhaps it is also timely for the government to consider harmonising these differences under Budget 2026. A Malaysian tax res-

ident company should not be precluded from certain exemptions despite being incorporated overseas, which is typically for other commercial reasons.

Finally, while the government has gone down the right path of not implementing a "one-size-fits-all" approach for ESR under these exemption orders as it acknowledges that this will vary by industry; it could, however, consider a mechanism for taxpayers wishing to obtain written confirmation of their ESR compliance for certainty. The current Advance Ruling mechanism may not cater to this as it appears to be for legislative interpretation only and not for factual determination. ESR is a question of fact. Opening such avenues not only enhances the maturity of interaction between taxpayer and taxman but is also consistent with other countries like Hong Kong and Singapore.

It will definitely be an unexpected bonus if other foreign-sourced income, such as interest and royalties, is also included in the exemption orders. For now, however, the priority is for these exemptions to be extended as businesses gear up to speedily diversify into other countries in response to the US tariffs and also the government's call for local businesses to broaden their horizons. ■

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