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Inclusion of Malaysia into
European Union's Tax "Grey"
List



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Inclusion of Malaysia into European Union's Tax "Grey" List

On 5 October 2021, the Council of the European Union (EU) included Malaysia into its list of jurisdictions which are committed to amend or abolish their harmful foreign source income exemption regimes (also referred to as the "Grey" List).



Background on Grey List

The EU's Code of Conduct Group (Business Taxation) ("COCG") reviews and assesses selected EU and non-EU jurisdictions' tax regime in relation to international tax standards, and to encourage positive change in the tax legislation and practices of these jurisdictions. Jurisdictions are selected on the basis of:

- Their economic ties with the EU
- Their institutional stability
- The importance of the country's financial sector

The Grey List is a list of jurisdictions which have responded to the EU's concerns with sufficient commitments to tax reforms within an agreed timeline (as compared to the "black" list which covers jurisdictions which are considered to be non-cooperative which are subject to defensive measures such as withholding tax measures, non-deductibility of costs incurred, etc).

Since 2020, the list will be updated twice a year to include new jurisdictions which the EU has concerns with and to de-list those which have implemented measures to address the EU's concerns. The latest revision took place on 5 October 2021. The next revision is due in February 2022.

Malaysia's inclusion into the Grey List

On 25 November 2019, Malaysia, along with Hong Kong, Costa Rica, Qatar and Uruguay, were added to the list of preferential tax regimes to be reviewed. Following the review, Malaysia has now been included in the Grey List. The inclusion of Malaysia into the Grey List pertains only to the foreign source income exemption (FSIE) aspects of the Malaysian tax regime. It is important to note that the EU does not consider FSIE regimes or regimes that charge corporate tax on a territorial basis to be by themselves, problematic. In fact, exempting foreign profits is acceptable and even recommendable, especially to prevent double taxation. However, problems arise when such regimes not only prevent double taxation, but also create situations of double non-taxation.

Malaysia's inclusion into the Grey List (cont'd)

The review focuses on FSIE regimes that have:

- an overly broad definition of the income excluded from taxation, notably foreign source passive income without any conditions or safeguards, and/or
- a nexus definition [business income] that is non-compliant with the definition of a permanent establishment in the OECD Model Tax Convention.

Implications for Malaysia

The law governing FSIE is provided under Paragraph 28 of Schedule 6, Income Tax Act 1967 which specifies that income of any person, other than a resident company carrying on the business of banking, insurance or sea or air transport, for the basis year for a year of assessment derived from sources outside Malaysia and received in Malaysia, shall be exempted.

The specific reasons for including Malaysia into the Grey List have not been publicly disclosed at this point in time. As Malaysia's Double Taxation Agreements are generally modelled after the OECD Model Tax Convention, it is unlikely that the tax treatment of business income would be the reason of EU's concern. Based on the requirements of the law, passive income is exempted from Malaysian income tax so long as it can be proven that its source is from outside Malaysia. It would appear that the reason for Malaysia's inclusion into the Grey List is likely to be in relation to passive income.

The EU requires a jurisdiction which has harmful FSIE regime to either amend its legislation so that foreign-sourced income is no longer exempted, or to put in place the necessary safeguards such as:

- Adequate substance requirements.
- Robust anti-abuse rules.
- Removal of any administrative discretion in determining the income to be excluded from taxation.



Malaysia's response

Malaysia, has on 3 August 2021 and 20 September 2021 sent letters to the COCG Chair on Malaysia's commitment to repeal or amend the harmful FSIE regime. Malaysia has been granted **until 31 December 2022** to make the necessary amendments to or abolish the law on exemption of foreign source income.

Concluding remarks

The Malaysian Government has not issued any official announcement on plans to approach this matter. Whilst it is important to address the immediate need to be removed from the Grey List, Malaysia should carefully consider the issue in a holistic and inclusive manner. Given that Malaysia has a long standing territorial scope of taxation, a total removal of the FSIE regime must be carefully considered. It may be sufficient to retain the FSIE regime but put in place the necessary qualifying conditions.

Malaysia could also observe the approach taken by other countries in the Grey List and also countries which have an FSIE regime but have not been included in the Grey List such as Singapore. In Singapore, the classes of income which are exempted are specified. These comprise of foreign-sourced dividend, foreign branch profits and foreign-sourced service income. Conditions to be met in order for these classes of income to be exempted include:

- The income has been subject to tax in the foreign jurisdiction from which it was received.
- The corporate tax rate of the foreign jurisdiction is at least 15%.
- The tax exemption must be beneficial to the person resident in Singapore.

Foreign-sourced interest income on the other hand, is taxable when it is remitted or deemed to be remitted to Singapore.

It is important that in deciding on the course of action to be taken in responding to the EU, the following are taken into consideration: views of stakeholders, the ongoing discussions on global minimum tax, Malaysia's commitment as a business friendly jurisdiction and commitments to the OECD's BEPS Inclusive Framework.



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