TaXavvy

3 October 2022 | Issue 19-2022

Guidelines on Tax Treatment of Income Received from outside of Malaysia

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Following the gazette of the Income Tax (Exemption) (No. 5) Order 2022 and Income Tax (Exemption) (No. 6) Order 2022 ("Exemption Orders") in relation to tax exemption on specified FSI (refer TaXavvy 13-2022), the Inland Revenue Board ("IRB") has issued the Guidelines on Tax Treatment of Income Received from outside of Malaysia ("IRB Guidelines").

The IRB Guidelines (in Bahasa Malaysia only) is available on IRB's website www.hasil.gov.my (Legislation > Guidelines > Technical Guidelines).

Recap on scope of exemption of foreign-sourced income (FSI) based on the Exemption Orders

<table>
<tr><td colspan="2">Exemption period</td><td>Qualifying FSI received in Malaysia from outside Malaysia from 1 January 2022 to 31 December 2026 (5 years)</td></tr>
<tr><td rowspan="2">FSI exempted from tax</td><td>Resident individuals (excluding a source of income from a partnership business in Malaysia, which is received in Malaysia from outside Malaysia)</td><td>All sources of income under Section 4 of the Income Tax Act 1967, which comprise:
(a) gains or profits from a business;
(b) gains or profits from an employment;
(c) dividends, interest or discounts;
(d) rents, royalties or premiums;
(e) pensions, annuities or other periodical payments not falling under any of the above; and
(f) gains or profits not falling under any of the above.</td></tr>
<tr><td>Resident individuals (in respect of dividend income received through a partnership business in Malaysia)

Resident companies and LLPs</td><td>Dividend income which is received in Malaysia from outside Malaysia

(Resident companies carrying on the business of banking, insurance, sea or air transport, continue to be taxed on income from wherever derived.)</td></tr>
</table>

Note: Companies and LLPs will continue to be subject to tax on other types of FSI other than dividend income (e.g. interest, royalty, branch profits, etc) that is received in Malaysia from outside Malaysia from 1 January 2022 at the following income tax rates:

- *Amounts received from 1 January 2022 to 30 June 2022 - 3% gross*
- *Amounts received after 30 June 2022 - prevailing income tax rate*

The IRB Guidelines

The IRB Guidelines covers matters in relation to tax exemption of FSI under the Exemption Orders including:

- Conditions to qualify for exemption from income tax on foreign-sourced dividend received by resident companies, LLPs and individuals (in respect of dividend income received through a partnership business in Malaysia)
- Conditions to qualify for exemption from income tax on foreign-sourced income received by resident individuals
- Tax administration - declaration in tax return and supporting documentation
- Computation of foreign tax credit on FSI which is subject to tax
- Interaction of FSI which is subject to tax with Cukai Makmur

Conditions imposed by MoF under the Exemption Orders

The Exemption Orders state that the following qualifying conditions are subject to compliance with conditions imposed by the Minister of Finance (MoF) as specified in the guidelines issued by the IRB:

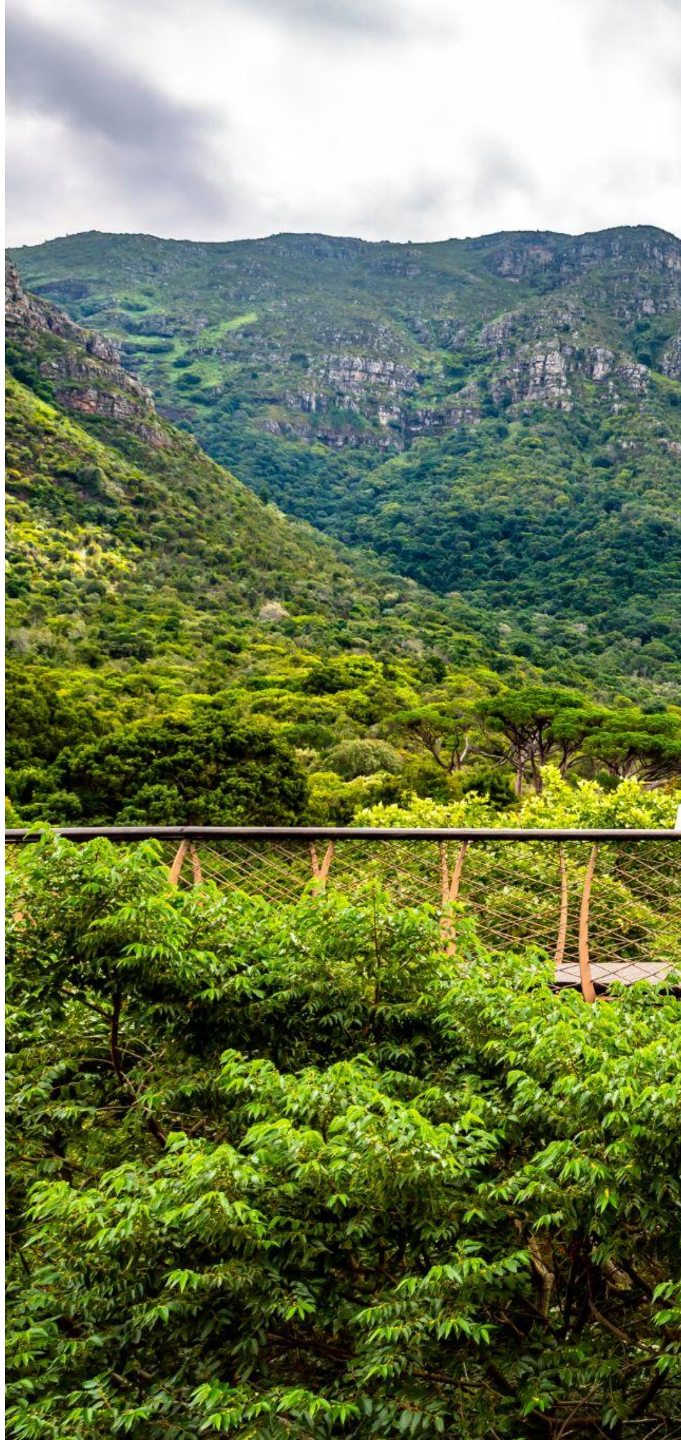
1. The FSI received in Malaysia shall have been subject to foreign tax, i.e. tax of a similar character to income tax under the law of the territory where the income arises **("subject to foreign tax condition")**; and
2. In relation to dividend income (in addition to the subject to foreign tax condition above), the highest rate of tax of a similar character to income tax charged under the law of the territory where the income arises at that time is not less than 15% **("minimum 15% foreign tax rate condition")**.

The MoF's conditions are now specified in the IRB Guidelines.

Subject to foreign tax condition in relation to dividend income [conditions in Paragraph 5.2.1.3 (a) of the IRB Guidelines]	Dividend income is regarded to have been subject to foreign tax if: (a) Income tax / withholding tax (WHT) on the dividend is paid or payable; or (b) It has been subject to “underlying tax”, i.e. the foreign tax paid or payable by the dividend payer company on its profits from which the dividends are paid from. *<u>Comment</u>:* The concept of underlying tax is in recognition that dividend is essentially a post-tax income, i.e. tax has been paid on the profits from which the dividend is paid out. The dividend is regarded to have been subject to underlying tax in the event that no tax is paid by the dividend payer company by reason of: ● unabsorbed losses or capital allowance; ● profit is attributable to a capital gain; ● a tax incentive that is conditioned on fulfilling substance requirements; or ● tax rules under a tax consolidation regime. The subject to foreign tax condition is regarded to be satisfied when: ● Either the income tax / WHT, or underlying tax is applicable; or ● Both the income tax / WHT, and underlying tax are applicable. These are explained and illustrated in paragraph 5.2.1.3(a) and *Lampiran 1*, *Lampiran 2(a)* and *Lampiran 2(b)* of the IRB Guidelines.

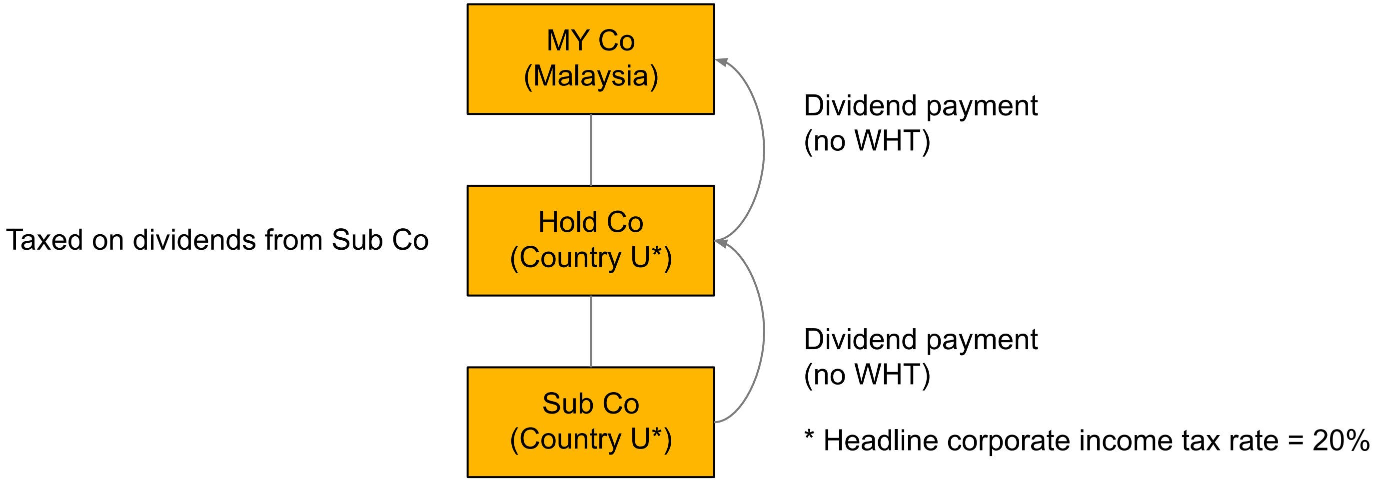
Subject to foreign tax condition in relation to FSI received by resident individuals [conditions in Paragraph 5.2.2 of the IRB Guidelines]	FSI received by individuals is regarded to have been subject to foreign tax if: (a) income tax / withholding tax (WHT) on the FSI has been paid or is payable; or (b) no foreign tax is paid or payable by reason of: ● Taxation system of the source (foreign) jurisdiction *<u>Example: Remittance of income from employment exercised in Brunei</u>* *Income arising from employment exercised in Brunei is regarded to have been subject to foreign tax (Refer to Example 6 of the IRB Guidelines).* ● The FSI of the individual fell below the taxable threshold in the source (foreign) jurisdiction ● Exemption on income due to tax incentive *<u>Example: Withdrawal of savings from retirement fund in relation to employment in Singapore</u>* *Amount received in Malaysia is regarded to have been subject to tax in Singapore and is therefore exempted from Malaysian income tax under the Exemption Order (Refer to Example 8 of the IRB Guidelines).* ● In the case of dividend income, it has been subject to an underlying tax ● In the case of dividend income, no underlying tax is payable due to: ○ unabsorbed losses or capital allowance; ○ profit is attributable to a capital gain; ○ tax incentive that is conditioned on fulfilling substance requirements; or ○ tax rules under a tax consolidation regime. These are explained and illustrated in paragraph 5.2.2 of the IRB Guidelines.

Minimum 15% foreign tax rate condition in relation to dividend income [conditions in Paragraph 5.2.1.3 (b) of the IRB Guidelines]	Under the Income Tax (Exemption) (No. 6) Order 2022, it is stated that: *"the highest rate of tax of a similar character to income tax charged under the law of the territory which the income arises at <u>that time</u> is not less than fifteen percent."* *Clarity was required on whether the minimum 15% foreign tax rate refers to the prevailing tax rate at the time when the:* *(i) income is subject to tax in the foreign country; or* *(ii) income is received in Malaysia.* In this respect, the IRB Guidelines states that the highest tax rate (referred to as "headline tax" rate in the IRB Guidelines refers to the highest prevailing tax rate of the year <u>when the dividend is subject to tax in the foreign country</u>, and the rate need not necessarily be the actual tax rate that is imposed on the dividend income. In Example 5 of the IRB Guidelines, the subject to foreign tax condition is considered to be met under the following conditions even though the dividend WHT rate of 10% (actual) is below 15% as the headline corporate income tax rate at the time when the dividend is subject to tax in the foreign country is not less than 15% as follows: ● Gross dividend received by Syarikat Deco in its account in country T on 15 Feb 2021: RM20,000 ● Withholding tax imposed on dividend in country T: RM2,000 (i.e. at 10%) ● Net dividend received in Country T: RM18,000 ● Headline corporate income tax in country T in 2021: 20% Syarikat Deco is exempted from Malaysian income tax when the dividend is transferred to its account in Malaysia on 5 Jan 2022.

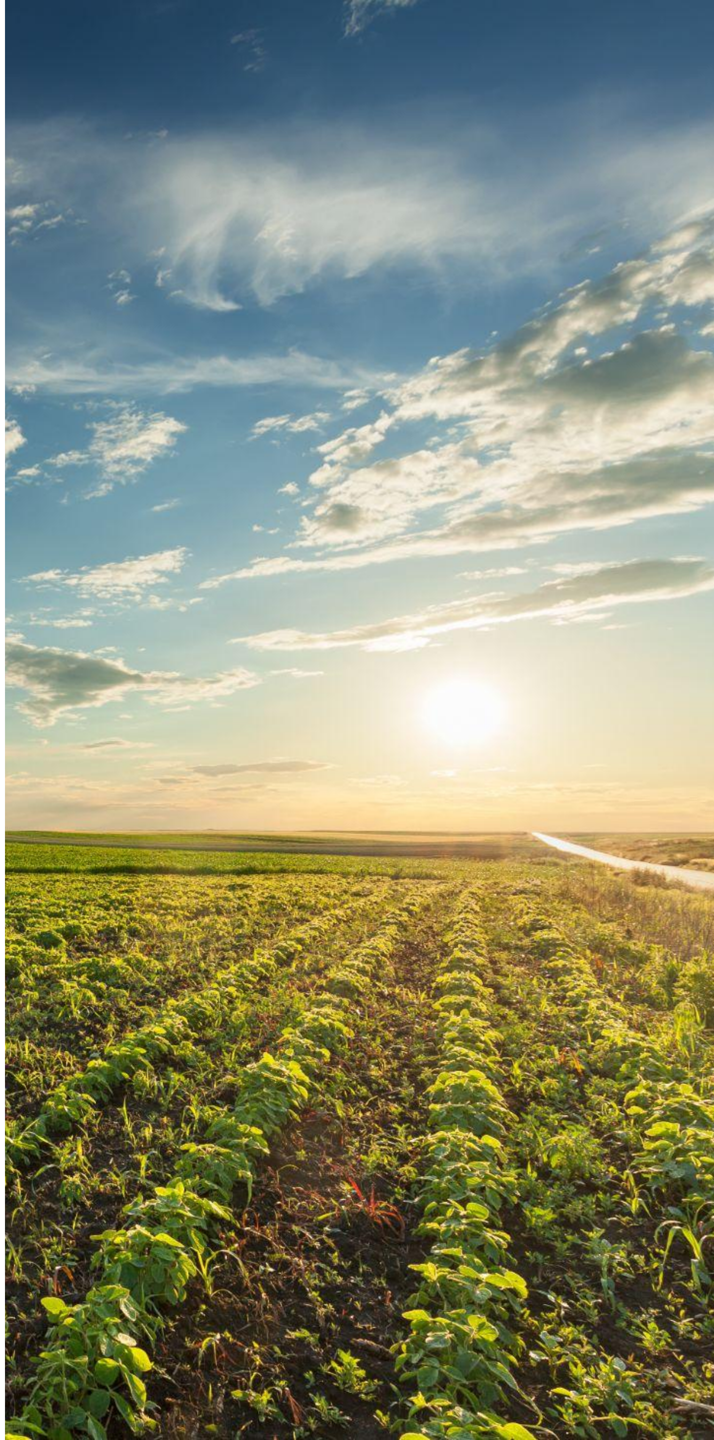


An illustration on the satisfaction of the qualifying conditions under the Income Tax (Exemption) (No. 6) Order 2022 (read together with the IRB Guidelines) is set out below:

Illustration 1 (Foreign-sourced dividend received by resident company is tax exempt)

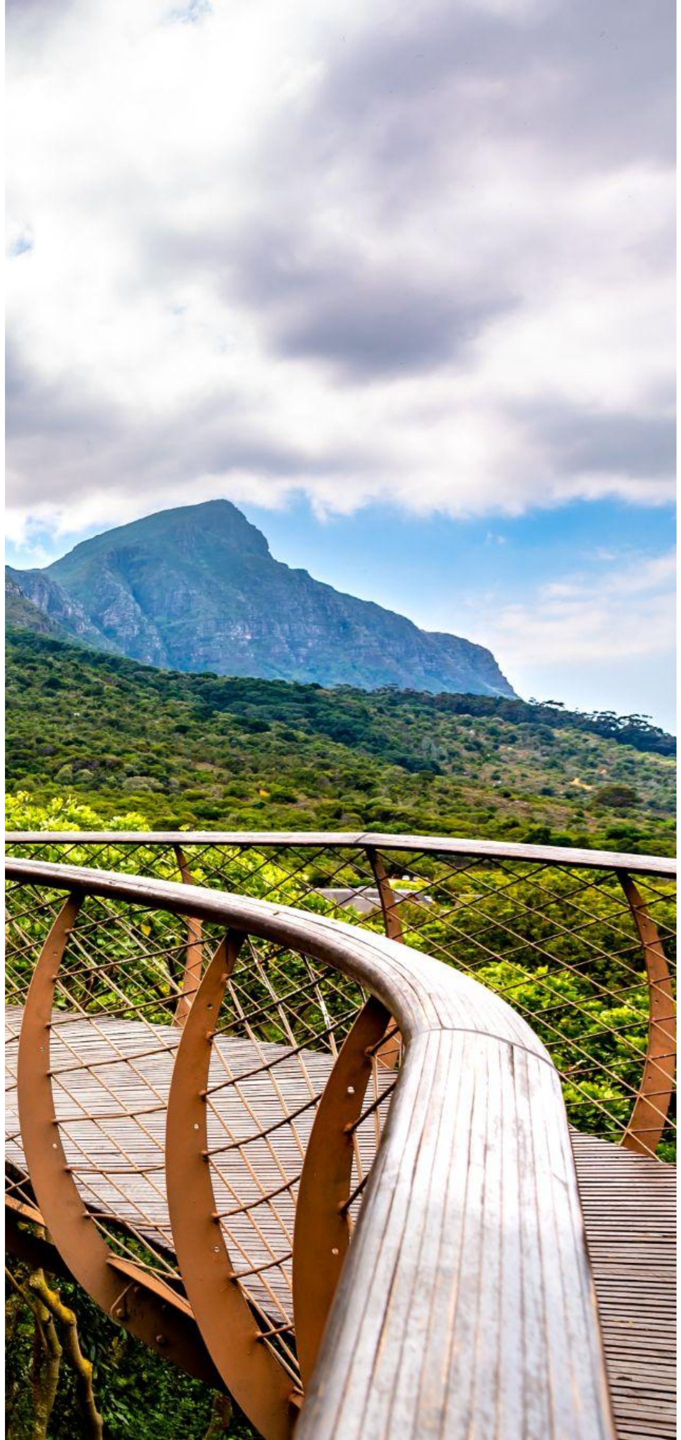


Conditions	Met?	
Subject to foreign tax	✔	Underlying tax is suffered at Hold Co's level on profits (dividend from Sub Co) which are used to pay dividend to MY Co
Minimum 15% foreign tax rate	✔	Hold Co is in a country with a headline corporate income tax rate of at least 15%



Meaning of "income received in Malaysia from outside Malaysia"	Received in Malaysia means transferred or brought into Malaysia through either the following:

Medium	Meaning
Cash	• Bank notes • Coins • Cheques
Electronic funds transfer (EFT)	• Bank transfer (e.g. credit / debit transfer) • Payment card (debit card, credit card and charge card) • Electronic money (e-money) • Privately-issued digital asset (e.g. crypto-assets, stablecoins) • Central bank digital currency



Other salient points from the IRB Guidelines

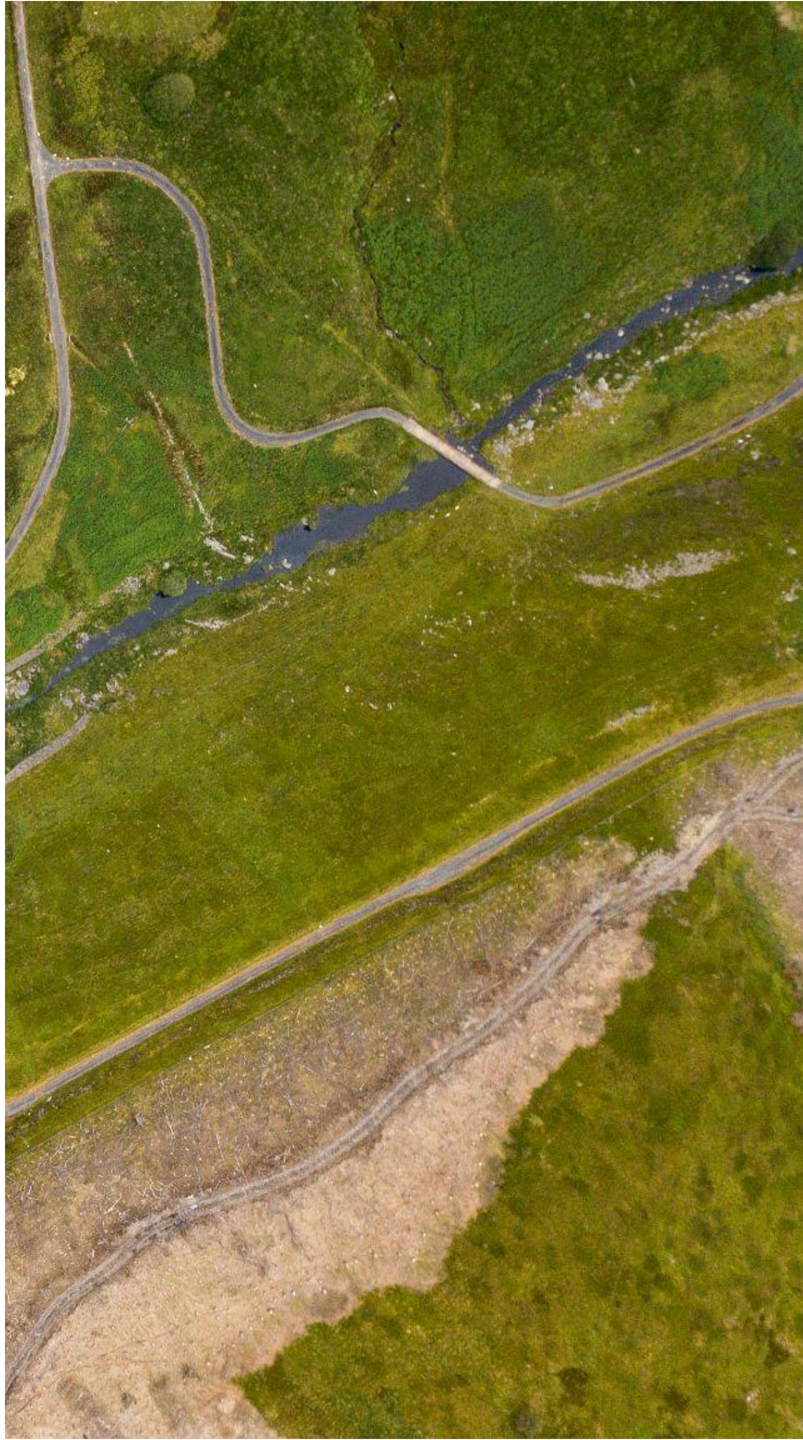
Deductibility of expenses in relation to FSI
The IRB has provided guidance that direct expense incurred in a year which is attributable / proportionate to the FSI remitted is tax deductible. This is illustrated in Example 4.

Foreign tax credit (FTC)
FTC is available against FSI that is subject to Malaysian income tax. The IRB Guidelines clarifies that FTC is also available for FSI received during the period from 1 January 2022 to 30 June 2022 that is subject to the 3% (gross) tax rate. Refer to Example 2 of the IRB Guidelines for details.

Supporting documents and declaration in tax returns
Taxpayers are required to retain supporting documents to prove that the FSI has been subject to foreign tax such as dividend voucher and notice of tax assessments.

Taxpayers are also required to make a declaration in their Malaysian income tax return that the relevant FSI qualifies for tax exemption and provide details on the following:

- Type and amount of FSI
- Source country from which the FSI is derived
- Headline tax rate of the foreign country (for companies and LLPs)
- Total tax suffered in the foreign country



Other salient points from the IRB Guidelines (cont'd)

Cukai Makmur

FSI that is received in YA 2022 is not subject to *Cukai Makmur* (the one-off 33% tax rate applicable on the portion of chargeable income in excess of RM100 million for YA 2022 only). This is illustrated in Examples 10 and 11 of the IRB Guidelines. Extracts of these examples are set out below for reference:

Example 10

Income for YA 2022

Income	RM' mil
Statutory income (business)	150
Statutory income (FSI - interest)	25
Total income/Chargeable income	175

Tax computation

Chargeable income (RM' mil)	Tax rate (%)	Tax payable (RM)
First 100	24	24
Next 50	33	16.5
25 (FSI - interest)	***24***	6
Total		46.5

Example 11

Income for YA 2022

Income	RM' mil
Statutory income (business)	95
Statutory income (FSI - interest)	25
Total income/Chargeable income	120

Tax computation

Chargeable income (RM' mil)	Tax rate (%)	Tax payable (RM)
First 95	24	22.8
25 (FSI - interest)	***24***	6
Total		28.8

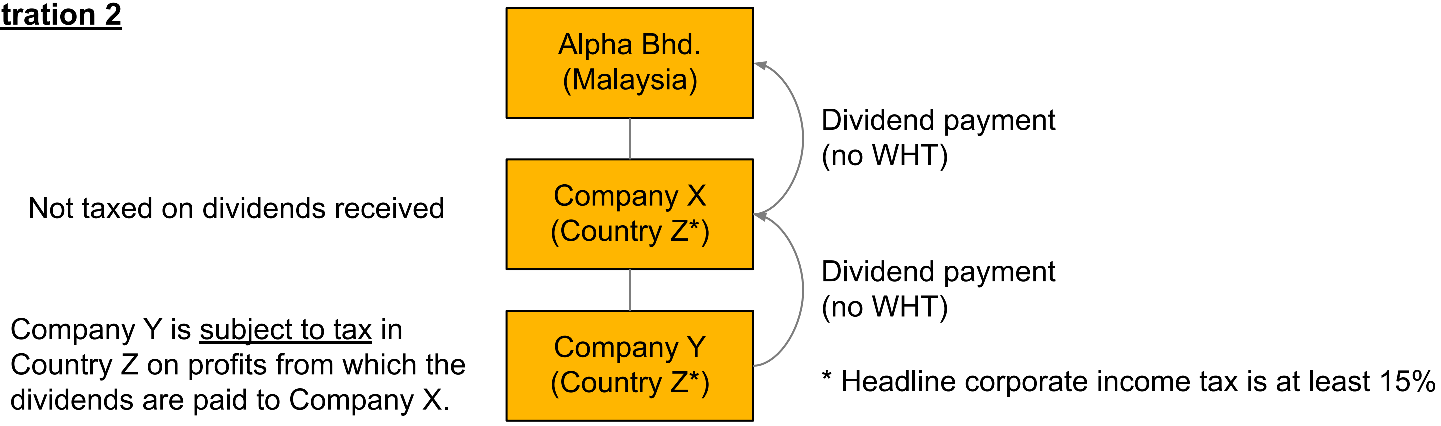
Observations

1. Qualifying conditions in relation to foreign investment holding structures

It is not uncommon for Malaysian-based companies to invest in foreign operations (entity) via a medium of intermediary holding companies.

Based on a strict reading of the Income Tax (Exemption) (No. 6) Order 2022 (read together with the IRB Guidelines), it appears that the qualifying conditions (as explained in the previous pages) are effectively required to be met at the level of immediate dividend paying company. The IRB has confirmed this from the illustration found in *Lampiran 1* of the IRB Guidelines, reproduced as follows (where Alpha Bhd will not be exempted from tax on dividends received from Company X):

Illustration 2



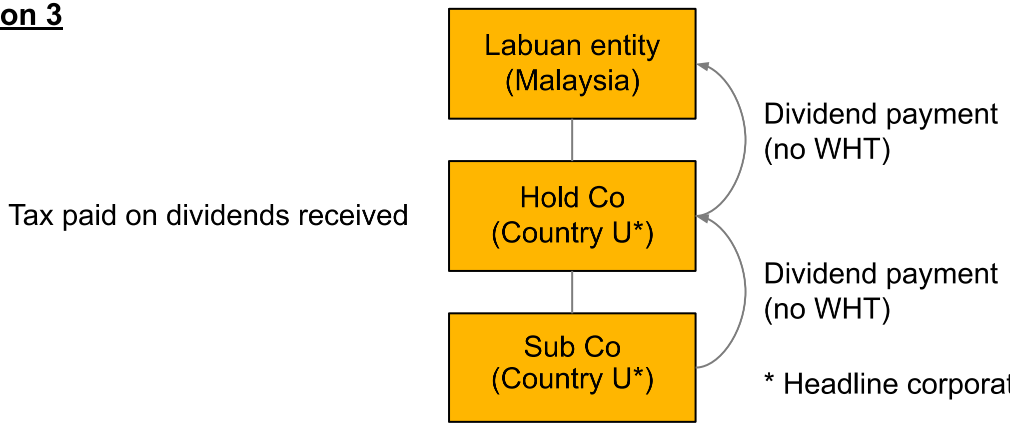
Conditions	Met?	
Subject to foreign tax	✘	No underlying tax is suffered at Company X's level on profits (dividend from Company Y) which are used to pay dividend to Alpha Bhd, and no WHT on dividend from Company X.
Minimum 15% foreign tax rate	✔	Company X is in a country with a headline corporate income tax rate of at least 15%

Observations (cont'd)

2. Labuan entities

The Income Tax (Exemption) (No. 6) Order 2022 does not include a Labuan entity as a qualifying person for the purposes of the tax exemption on dividend income which is received in Malaysia from outside Malaysia. It is hoped that the authorities will consider the exemption for Labuan entities which are subject to tax under the Income Tax Act 1967 in order to preserve the attractiveness of Labuan IBFC.

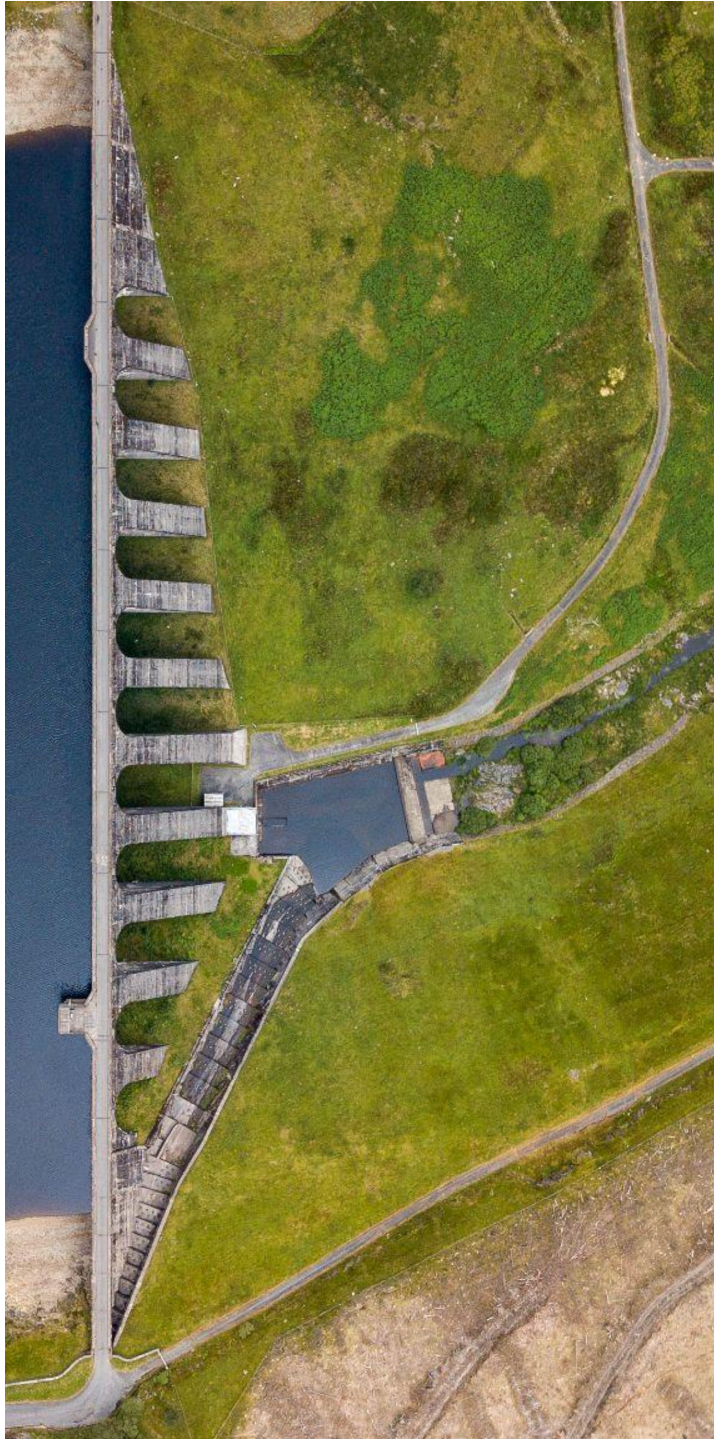
Illustration 3



* Headline corporate income tax rate = 20%

Conditions	Met?	
Subject to foreign tax	✔	Underlying tax is suffered at Hold Co's level on profits (dividend from Sub Co) which are used to pay dividend to MY Co
Minimum 15% foreign tax rate	✔	Hold Co is in a country with a headline corporate income tax rate of at least 15%

Although the subject to foreign tax condition and the minimum 15% foreign tax rate condition have been satisfied, the resident recipient in this case being a Labuan entity **will not be eligible for the tax exemption** as a Labuan entity is not listed as a qualifying person under the Income Tax (Exemption) (No. 6) Order 2022.



Observations (cont'd)

3. Implications on foreign investment structures

There is a critical need to review the tax impact on the FSI remitted to Malaysia as the the details of the FSI exemption, as set out in the IRB Guidelines does not appear to cover certain existing investment holding structures.

4. Supporting documentation

Whilst the IRB has set out types of documents that are required to be maintained to substantiate the tax treatment adopted [such as type and amount of FSI, source country from which the FSI is derived, headline tax rate of the foreign country, total tax suffered in the foreign country, etc], there could be practical / transitional challenges faced by taxpayers to establish these information, e.g. information related to income earned in previous years but remitted to Malaysia from 1 January 2022.

Date:

17 October 2022

Time:

9.00am to 12.30pm

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