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Amended Guidelines on Foreign-sourced Income

The IRB has issued the Guidelines on Tax Treatment of Income Received from Abroad (Amendment) dated 29 December 2022 (“Amended FSI Guideline”).

The first edition of the guideline was issued on 29 September 2022 (“FSI Guideline”). Amongst others, it covered the following matters in relation to tax exemption of FSI under the Income Tax (Exemption) (No. 5) Order 2022 and Income Tax (Exemption) (No. 6) Order 2022, (“Exemption Orders”), including:

(a) 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)
(b) Conditions to qualify for exemption from income tax on foreign-sourced income received by resident individuals

Please refer to TaXavvy 19-2022 for details.

Brief recap on conditions for exemption on foreign-sourced dividend in (a) above

The Exemption Orders state that the following qualifying conditions are subject to compliance with conditions imposed by the Minister of Finance as specified in the FSI Guideline:

- 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; and
- 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%.

Key amendment - Requirement to comply with economic substance requirements

In addition to the conditions already spelt out previously, resident companies, LLPs and individuals (in relation to a partnership business in Malaysia) are required to **comply with economic substance requirements** in order to qualify for the tax exemption on foreign-sourced dividend income received in Malaysia from outside Malaysia.

A resident company, LLP, and individual (in relation to a partnership business in Malaysia) shall be regarded as having economic substance if it has:

- employed adequate number of employees with necessary qualifications to carry out the specified economic activities in Malaysia; and
- incurred adequate amount of operating expenditure for carrying out the specified economic activities in Malaysia.

The Amended FSI Guideline states that it is neither feasible nor appropriate to specify any minimum thresholds for the above economic substance requirements which are dependent on the facts of each case. Factors which will be taken into account include:

- the number of employees having regard to the nature of the relevant activities, e.g. whether the industry is capital or labour-intensive;
- whether the employees are employed on a full-time or part-time basis; and
- whether office premises have been used for undertaking the relevant activities and whether the premises are adequate for such activities.

PwC's Comment

The economic substance requirements are similar to those which have been implemented for the purposes of the Labuan Business Activity Tax Act 1990 (LBATA), which generally took effect from 1 January 2019 in pursuance to Malaysia's commitment under the OECD's BEPS Action 5 on Harmful Tax Practices.

On 5 October 2021, the Council of the European Union (EU) included Malaysia into its list of jurisdictions which are "committed to amending or abolishing their harmful foreign-sourced income exemption regimes, by 31 December 2022" (also referred to as the "Grey" List). The condition-based tax exemptions which are provided under the Exemption Orders read together with conditions spelt out under the FSI Guideline dated 29 September 2022 were steps taken to address the EU's concern. The inclusion of the economic substance requirements is likely to be another step in pursuance to this commitment.

Unlike the economic substance requirements under LBATA where thresholds have been prescribed depending on the types of activities carried out in Labuan, no thresholds will be specified as stated in the Amended FSI Guideline. While the case-to-case approach provides flexibility in that the requirements should be proportionate to the situation of the respective taxpayer, some immediate concerns are:

- How will the economic substance requirements impact taxpayers which have relied on the previous conditions.
- Whether the economic substance requirements will be applicable prospectively.
- Whether taxpayers are required to obtain pre-approval from the authorities prior to claiming the tax exemption in its tax returns.

We hope the tax authorities will provide clarifications to taxpayers at an early date and that the additional conditions will be applied prospectively.