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Updated Foreign-Sourced Income Guideline

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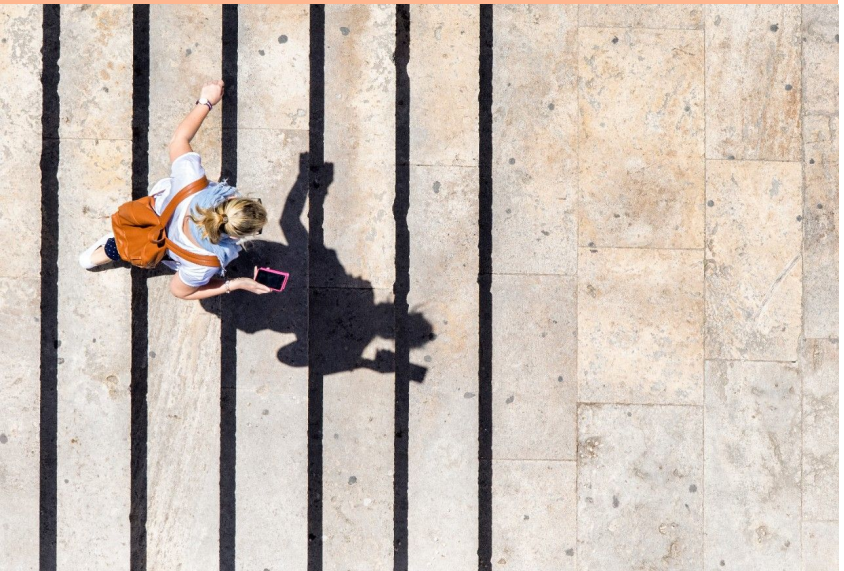
Following the gazette of the Income Tax (Exemption) (No. 6) Order 2022 (Amendment) Order 2024, the Inland Revenue Board (IRB) has issued the Updated Guidelines on Tax Treatment in relation to Income Received from Abroad ("2024 FSI Guidelines") on 20 June 2024.



In brief

The 2024 FSI Guidelines was issued following the recent gazette of the Income Tax (Exemption) (No. 6) Order 2022 (Amendment) Order 2024 ("Amendment Order") (refer TaXavvy 21-2024). It also takes into account various refinements since its was first issued in September 2022. Highlights from the 2024 FSI Guidelines are:

- Taxpayers may choose whether to comply with (i) economic substance requirements or (ii) subject to tax and minimum tax rate of 15% condition. The choice is effective retrospectively from 1 January 2022. *Taxpayers which did not meet both conditions previously and have paid tax on the dividend received may now consider revising their tax returns on the basis of meeting either one of the conditions.*
- In line with the Amendment Order, companies which are eligible for tax exemption on foreign-sourced dividend income include Labuan companies which have made an election to be subject to income tax.
- Guidance is now given on the types of activities that is carried out for the purposes determining whether an entity is considered as an investment holding entity for the purpose of economic substance requirements.
- A service director who is employed based on contract of service can be considered as an employee for the purpose of meeting economic substance requirements.
- Outsourcing of specified economic activities to an outsourcing entity for the purpose of meeting economic substance requirement is permitted, subject to observing conditions.
- For individuals, the qualifying conditions for exemption of foreign-sourced dividend income has now been clarified. Under the list of exceptions to the condition that tax has been imposed in the country of origin of the foreign-sourced income, the exceptions listed under the previous guideline have now been clearly segregated between (i) exceptions which applies to dividend income and (ii) exceptions which applies to income other than dividend income. Please refer to the table in page 6.

The enabling legislation / guidelines in relation to the FSI exemption for unit trusts which was announced earlier this year is still pending.

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

The conditions for FSI exemption are outlined in the table below. Key details of the conditions are set out in the following page.

Taxpayer category	*FSI exempted from tax*	*Exemption period*
1. Resident individuals (excluding a source of income from a partnership business in Malaysia, which is received in Malaysia from outside Malaysia)	All sources of FSI subject to tax under section 4 of the Income Tax Act 1967, which comprise: 1. gains or profits from a business, 2. gains or profits from an employment, 3. dividends, interest or discounts, 4. rents, royalties or premiums, 5. pensions, annuities or other periodical payments not falling under any of the above, and 6. gains or profits not falling under any of the above.	Qualifying FSI received in Malaysia from outside Malaysia from 1 January 2022 to 31 December 2026 (5 years)
2. Resident individuals (in respect of dividend income received through a partnership business in Malaysia)	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)	
3. Resident companies, Labuan companies which have made an election to be subject to income tax and limited liability partnerships (LLPs)		

Qualifying conditions for exemption

The key conditions for FSI exemption are outlined in the table below.

Taxpayer category	*Condition for exemption*
1. Resident individuals (excluding a source of income from a partnership business in Malaysia, which is received in Malaysia from outside Malaysia)	The income has been subjected to tax in the country of origin.
2. Resident individuals (in respect of dividend income received through a partnership business in Malaysia) *3. Resident companies, Labuan companies which have made an election to be subject to income tax and LLPs*	The 2024 FSI Guidelines has now incorporated the **choice** of conditions to be satisfied as per the Amendment Order. More notably, the 2024 FSI Guidelines provides for this choice to be made retrospectively **from 1 January 2022**. The choices of conditions to satisfy are: **Option A (now collectively referred to as "participation exemption" requirements)** 1. **Subject to foreign tax condition:** The income received in Malaysia has been subject to foreign tax**,** i.e. tax of a similar character to income tax under the laws of the territory where the income arises, *and* 2. **Headline 15% foreign tax rate condition:** The highest rate of tax of a similar character to income tax charged under the law of the territory where the income arises is not less than 15%, *OR* **Option B - Economic substance requirements (ESR) condition:** a. employed adequate number of employees with necessary qualifications to carry out the specified economic activities in Malaysia, and b. incurred adequate amount of operating expenditure for carrying out the specified economic activities in Malaysia.

Headline tax rate

A headline tax rate of not less than 15% refers to the highest corporate tax rate in the country where the income arises:

1. In the year the dividend is subject to withholding tax, or
2. In the year the dividend is received in Malaysia.

A new example 6 of the 2024 FSI Guideline illustrates that where no withholding tax is imposed on the dividend, the headline tax rate refers to the headline tax rate of the year in which the dividend was paid out of the underlying profits of the foreign company.

Specified economic activities

Specified economic activities has been explained in the 2024 FSI Guidelines to be:

1. In relation to an investment holding entity:
   - Holding and managing its equity participation in other entities, or
   - Making necessary strategic decisions in respect of any assets the entity acquires, holds or disposes of, and managing and bearing principal risks in respect of such assets.

2. In relation an entity other than an investment holding entity:
   In the case of a Company / LLPs / individual partner in relation to partnership business in Malaysia carrying out a trade, profession or business in Malaysia, specified economic activities refer to the business operations carried out.

Other details on ESR fulfilment

- A service director who is employed based on a contract of service and not a contract for service can be considered as an employee for ESR purposes.

- Outsourcing of specified economic activities is permitted, subject to fulfilling the following:
  a) The specified economic activities are carried out by the outsourced entity in Malaysia,
  b) The outsourcing party has exercised adequate monitoring and control on the carrying out of the specified economic activities by the outsourced entity,
  c) The outsourced entity is generally expected to charge the outsourcing party a fee for the specified economic activities performed subject to the application of transfer pricing rules,
  d) The number of qualified employees employed and the amount of operating expenditure incurred by the outsourced entity in Malaysia are in line with the level of specified economic activities carried out by the outsourced entity, and
  e) If the outsourced entity provides services to more than one outsourcing party, the computation of expenditure must be apportioned accordingly.

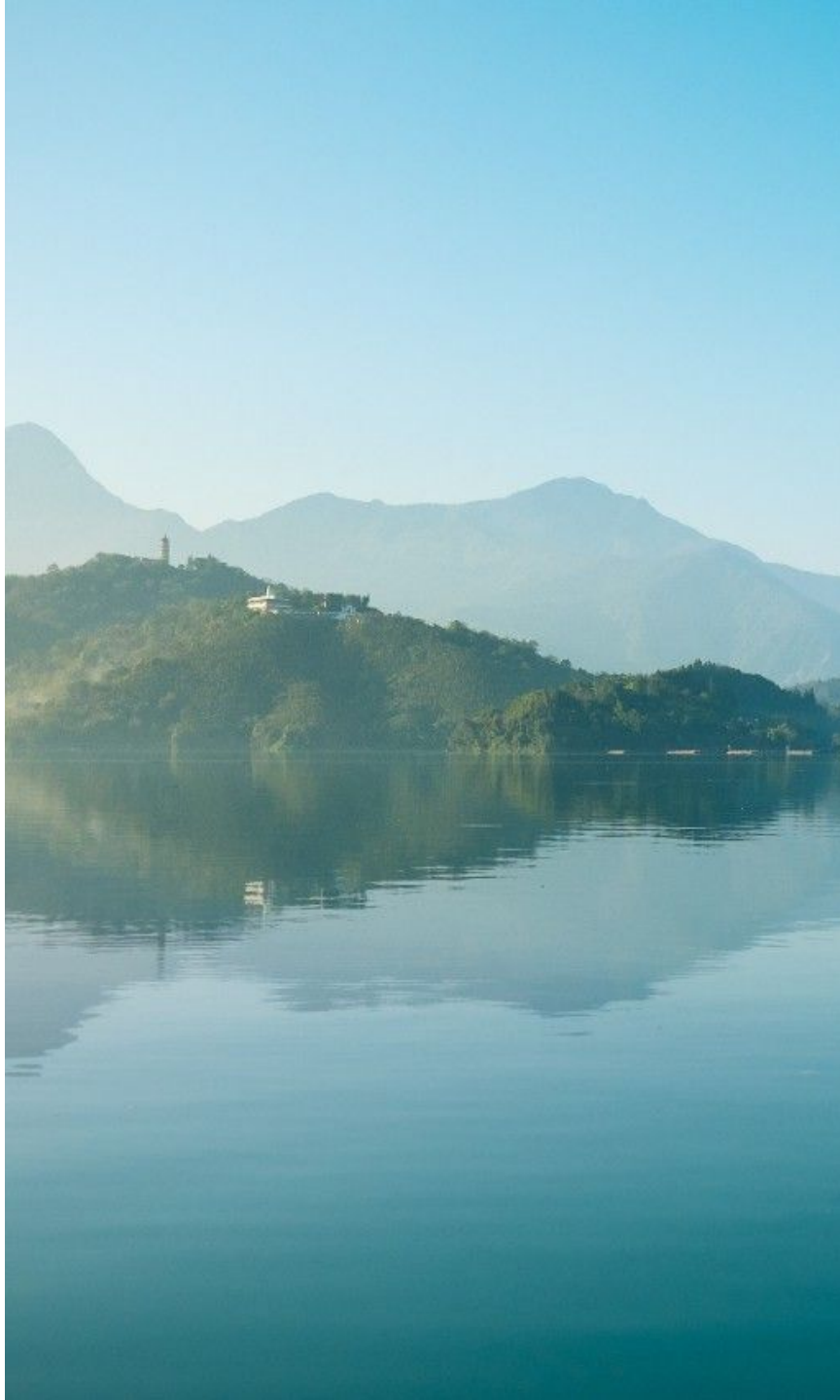
Qualifying conditions for exemption for foreign dividend income for individuals

For individuals, the qualifying conditions for exemption of foreign-sourced dividend income has now been clarified. Under the list of exceptions to the condition that tax has been imposed in the country of origin of the FSI, the exceptions listed under the previous guideline have now been clearly segregated between (i) exceptions which applies to dividend income and (ii) exceptions which applies to income other than dividend income. The exceptions are as follows:

Foreign income other than dividend income	*Foreign dividend income*
● Not subject to tax in country of origin due to the country's taxation system ● Not subject to tax in the country of origin because the individual's income does not reach the taxability amount in the country of origin ● The income is given an exemption through a tax incentive	● The dividend income has been subjected to underlying tax ● The dividend income is paid from underlying profits arising out of operating profits which has not been subjected to tax due to: a) Unabsorbed losses or capital allowances b) Arising from capital gains c) Enjoyed tax incentives in compliance with substantive requirements in the country, or d) Tax regulations under the tax consolidation regime in the country of origin

Computation (apportionment) of statutory income in respect of foreign income for foreign tax credit purposes

Example 1 has been amended where the statutory income from each jurisdiction is computed by directly deducting (was apportioned previously) the allowable expense against the gross income from the respective jurisdiction as the expense has been directly identified against its respective source of income. It can be observed that this approach is in line with the scenario under example 6 of Public Ruling 11/2021 - Bilateral Credit And Unilateral Credit.



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