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Guidelines on the tax treatment of income that is received from outside Malaysia

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The income tax exemption on foreign-sourced income (FSI) received by any person (other than a resident company carrying on the business of banking, insurance or sea or air transport) was removed for all Malaysian-resident taxpayers from 1 January 2022, pursuant to the Finance Act 2021. With this development, a flat income tax rate of 3% applies on the gross amount of FSI received in Malaysia from 1 January 2022 to 30 June 2022. From 1 July 2022 onwards, the prevailing tax rate of the taxpayer would apply on FSI received in Malaysia by Malaysian residents.

As highlighted in an earlier alert, the following Orders were gazetted on 19 July 2022 to provide that certain types of FSI of resident taxpayers will continue to be exempt from tax (see *Special Tax Alert No. 4/2022*):

- Income Tax (Exemption) (No. 5) 2022 [P.U.(A) 234], which applies to all sources of income of individuals, except for income from a partnership business in Malaysia
- Income Tax (Exemption) (No. 6) 2022 [P.U.(A) 235], which applies to the dividend income of companies, limited liability partnerships (LLPs) and individuals earning dividend income in relation to a partnership business in Malaysia.

The Orders are effective from 1 January 2022 to 31 December 2026.

One of the key points provided in both Orders is that to qualify for the exemption, the relevant taxpayers are required to comply with conditions imposed by the Ministry of Finance (MoF) as set out in the guidelines issued by the Inland Revenue Board (IRB). These guidelines were issued on 29 September 2022.

The Guidelines are in Bahasa Malaysia and are titled "Garis Panduan Layanan Cukai Berhubung Pendapatan Yang Diterima Dari Luar Negara". The Guidelines can be accessed at the following link.

As mentioned earlier, the Guidelines specify the conditions which must be complied with by taxpayers to qualify for the FSI exemption. The Guidelines also provide examples and annexes to explain and illustrate the tax treatment of FSI under various scenarios.

Some of the salient points are discussed below.

Meaning of "... *received in Malaysia*"

It was stipulated in both Orders that "income received in Malaysia from outside Malaysia" means income arising from outside Malaysia which is brought into Malaysia. The Guidelines further define the term "received in Malaysia" to mean transferred or brought into Malaysia, either by way of cash or electronic funds transfer.

"Cash" in this context is defined as banknotes, coins and cheques. "Electronic funds transfer" means bank transfers (e.g., credit or debit transfers), payment cards (debit card, credit card and charge card), electronic money, privately-issued digital assets (e.g., crypto-assets, stablecoins) and central bank digital currency. While these points are generally self-explanatory, it is not clear how income would be seen to be transferred or brought into Malaysia by way of "payment cards". It is possible that this is intended to mean that the payment of Malaysian debit cards, credit cards or charge card balances through foreign bank accounts would be treated as the said funds being "received in Malaysia", though it is hoped that further clarification will be provided by the IRB on this point.

Double taxation relief

Generally, where a Malaysian tax resident has suffered foreign taxes on FSI received in Malaysia, double taxation relief may be available to reduce the Malaysian tax payable on that FSI. Pursuant to Section 132 of the Income Tax Act 1967 (ITA), bilateral tax credits may be available where the jurisdiction in which the income arose (i.e., the foreign jurisdiction) has a double tax agreement (DTA) with Malaysia. Where there is no DTA between Malaysia and the foreign jurisdiction, unilateral tax credits may be available pursuant to Section 133 of the ITA.

The Guidelines highlight the importance of taxpayers retaining appropriate documentation to substantiate the amount of taxes paid in the foreign jurisdiction, in order to claim the tax credits. This is discussed further below. In addition, the Guidelines reiterate that foreign tax credits for a year of assessment (YA) must be claimed within two years after the end of that YA.

The Guidelines explain and provide examples to demonstrate the computation of the bilateral and/or unilateral credits under various scenarios, including the following:

- **Example 2** – This example illustrates the computation for a company in respect of YA 2022, where FSI was received between 1 January 2022 and 30 June 2022 (i.e., a flat income tax rate of 3% will apply on the gross amount of FSI) and from 1 July 2022 onwards (i.e., the prevailing tax rate will apply).

- **Example 3** – This example illustrates the computation for a company in respect of YA 2023, where FSI received in Malaysia in YA 2023 relates to income derived from multiple YAs (in this case, between YA 2020 and YA 2023). In such circumstances, the Guidelines stipulate that the onus is on the taxpayer to determine and prove that the FSI received in Malaysia is attributable to a specific YA. This is important to ensure that taxpayers apply the appropriate tax treatment on the FSI in their income tax returns, e.g., in ascertaining if the conditions for exemptions (discussed further below) were complied with in respect of the relevant YA (if applicable), the determination of the amount of expenses that can be claimed for deduction as well as the amount of foreign tax credits that can be claimed. The Guidelines also clarify that the foreign exchange rate to be used to convert FSI amounts into Ringgit Malaysia is the exchange rate on the date of remittance into Malaysia.

- **Example 4** – This example has the same facts as Example 3 (refer above), with an additional element of the taxpayer incurring interest expenses which are attributable to the FSI received in Malaysia.

Notwithstanding the above, the Guidelines do not explain whether the bilateral / unilateral credits are to be computed on a source-by-source, country-by-country or consolidated basis. It is hoped that further clarification will be provided by the IRB on this point. It is also hoped that the IRB will provide further guidance and examples of supporting documentation that is acceptable to substantiate the attribution of FSI to a specific YA.

Conditions in relation to the Income Tax (Exemption) (No. 5) 2022, which applies to all sources of income of individuals (excluding income from a partnership business in Malaysia)

Pursuant to the Order, the FSI exemption available to a qualifying individual[1] is conditional upon the FSI having been subjected to tax "of a similar character to income tax" under the laws of the foreign jurisdiction ("subject to tax" condition). For the purpose of this Order, the Guidelines provide that the "subject to tax" condition is considered to have been met where:

(i) The income has been subject to tax in the foreign jurisdiction – i.e., withholding tax (WHT) or income tax is paid or payable in the foreign jurisdiction

or

(ii) Tax is not imposed in the foreign jurisdiction due to the following:
  (a) Income is not subject to tax in the foreign jurisdiction because of the said jurisdictions' tax system
  (b) Income is not subject to tax in the foreign jurisdiction as the individual's income is below the stipulated threshold for the said income to be taxed

[1] 'Qualifying individual' means an individual resident in Malaysia who has income received in Malaysia from outside Malaysia

(c) Income is exempted from tax pursuant to tax incentives
(d) Dividend income has been subject to "underlying tax", i.e., income tax paid or payable in the foreign jurisdiction on underlying profits out of which the dividend is paid
(e) Dividend is paid from underlying profits which are not subject to tax due to the following:
  - Unutilized losses or capital allowances
  - The amounts are capital in nature
  - Tax incentives granted for substantive business activities carried out in the foreign jurisdiction
  - Tax consolidation regime in the foreign jurisdiction

Conditions in relation to Income Tax (Exemption) (No. 6) 2022, which apply to the dividend income of companies, LLPs and individuals earning dividend income in relation to a partnership business

Pursuant to the Order, the exemption on dividend income available to a qualifying person[2] is on condition that:

(a) The dividend income has been subjected to tax "of a similar character to income tax" under the laws of the foreign jurisdiction ("subject to tax" condition), and
(b) The "headline tax rate" (i.e., highest rate of tax "of a similar character to income tax" charged under the laws of the foreign jurisdiction) is at least 15%.

For the purpose of this Order, the Guidelines provide that the "subject to tax" condition is considered to have been met where the foreign-sourced dividend income:

(i) Has been subject to tax in the foreign jurisdiction, as follows:
  - WHT or income tax is paid or payable on the dividend income; or
  - The dividend has been subject to underlying tax. On this point, the Guidelines appear to indicate that underlying tax is limited to the tax paid by the entity from which the dividend is received. This is indicated for example in Note II of Paragraph 5.2.1.3(a), which specifically indicates that the underlying tax is only the tax of the entity paying the dividends. This note is replicated below, and is illustrated in Appendix 1 of the Guidelines.

    Nota II:
    Jika syarikat pembayar (Syarikat X) membayar dividen daripada dividen yang diterima daripada syarikat lain (Syarikat Y) (sama ada dalam negara yang sama dengan Syarikat X atau sebaliknya), underlying tax yang dibayar oleh Syarikat Y tersebut ke atas dividen itu tidak boleh dianggap sebagai cukai yang dibayar atau kena dibayar oleh Syarikat X bagi tujuan syarat kelayakan ini (rujuk ilustrasi di Lampiran 1).

[2] 'Qualifying person' means a person resident in Malaysia who is:
(a) An individual who has dividend income received in Malaysia from outside Malaysia in relation to a partnership business in Malaysia
(b) An LLP which is registered under the Limited Liability Partnerships Act 2012, or
(c) A company which is incorporated or registered under the Companies Act 2016

<Unofficial translation>

Note II:
If the paying company (Company X) pays dividends out of dividends received from another company (Company Y) (either from the same country as Company X or otherwise), the underlying tax paid by Company Y on the dividends cannot be considered as tax which is paid or payable by Company X for the purposes of this eligibility requirement (refer to the illustration in Appendix 1).

or

(ii) Has not been subject to tax in the foreign jurisdiction, because the dividend has been paid out of underlying profits which are not subject to tax due to the following:
- Unutilized losses or capital allowances
- The amounts are capital in nature
- Tax incentives granted for substantive business activities carried out in the foreign jurisdiction
- Tax consolidation regime in the foreign jurisdiction (see Appendices 2(a) and 2(b) of the Guidelines)

With regard to Point (b) above, the Guidelines clarify that the headline tax rate of 15% refers to the highest tax rate in the foreign jurisdiction at the time the dividend is taxed. The actual rate at which the income was taxed does not necessarily have to be the same as the headline tax rate (see Example 5 of the Guidelines).

Requirement to retain supporting documentation and declaration of exempted FSI

The Guidelines reiterate that pursuant to Sections 82 and 82A of the ITA, taxpayers are required to maintain sufficient documents (e.g., dividend vouchers, notice of assessments) to substantiate that the necessary conditions, especially the "subject to tax" condition, have been complied with. The records must be kept for a period of seven years from the relevant YA.

Taxpayers are required to declare and disclose certain information on tax-exempted FSI in their income tax return forms (reference can be made to Item F9 and the relevant appendix to the Form e-C for YA 2022). In addition, the supporting documents to substantiate the information outlined below should be retained and produced in the event of an audit by the IRB:

(a) Type and amount of income remitted
(b) Country of origin of the income
(c) Headline tax rate in the country of origin (for companies, LLPs and individuals earning income in relation to a partnership business)
(d) Amount of tax charged in the country of origin
(e) Individual's income that are not subject to tax in the country of origin
(f) Dividend income that has been subject to underlying tax
(g) Justifications on the inapplicability of underlying tax (if relevant)
(h) Verification letter or any other documentation to prove that incentive / income tax exemption has been granted by the tax authorities of the foreign jurisdiction, where relevant

Notwithstanding the above, it is hoped that the IRB will allow some leeway on the need for extensive documentation in respect of historical transactions, as well as the expectations for supporting documentation from minority shareholders (including individuals) who do not have controlling or substantial interest in the companies that pay the dividend and who hence would not have access to the dividend-paying company's tax and financial information. It is also hoped that the IRB will provide further guidance on the types of supporting documentation required to substantiate the information listed above.

FSI excluded from *Cukai Makmur*

Pursuant to the Finance Act 2021, a one-off corporate income tax rate of 33% (*Cukai Makmur*) is imposed on non-small and medium enterprises on chargeable income above RM100 million for YA 2022. Chargeable income of up to RM100 million will continue to be taxed at 24%.

As highlighted in an earlier alert, the Income Tax (Exemption) Order 2022 was gazetted on 5 April 2022 to provide that FSI received in YA 2022 will be excluded from the tax calculation for the purposes of the *Cukai Makmur* (see *Special Tax Alert No. 2/2022*).

The Guidelines reiterate the above position and provide examples (see Examples 10 and 11 of the Guidelines) to demonstrate the application of *Cukai Makmur* in cases where a company receives FSI in Malaysia in YA 2022.

Taxpayers that are not eligible for the exemption orders

As highlighted in our Special Tax Alert No. 4/2022, Labuan entities which have elected to be taxed under the ITA would not be able to apply the Income Tax (Exemption) (No. 5) 2022 or the Income Tax (Exemption) (No. 6) 2022. This is because Labuan entities are not listed as "qualifying persons" under either of the exemption orders. With respect to companies, the Income Tax (Exemption) (No. 6) 2022 only applies to a company which is incorporated or registered under the Companies Act 2016.

Similarly, Unit Trusts or Property Trusts, Co-operative Societies, Trust Bodies, Real Estate Investment Trusts or Property Trust Funds, Business Trusts, Associations, Deceased Persons' Estate and Hindu Joint Families will not qualify for the exemptions either.

The Guidelines do not provide any further clarification on this matter. It is hoped that this matter will be addressed soon.

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