

LHAG Insights

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Foreign Source Income: Untapped Source of Revenue or Fresh Hotbed of Uncertainty?

Public attention on Budget 2022 has thus far been focused on the Government's proposal to introduce a one-off "prosperity tax". This unprecedented proposal reportedly wiped off RM 33.8 billion of value from Malaysia's stock markets on the Monday after Budget 2022 was announced¹. Another significant element of Budget 2022 which should not be overlooked is the proposal to tax foreign source income received by Malaysian residents in Malaysia, with effect from 1 January 2022.

Background

Pursuant to s 3 of the Income Tax Act 1967 (ITA), the income of any person accruing in or derived from Malaysia, or received in Malaysia from outside of Malaysia, is subject to income tax. However, with effect from year of assessment (YA) 2004, foreign-sourced income received in Malaysia (other than income derived from the business of banking, insurance or sea or air transport) is exempted from income tax by virtue of paragraph 28(1), Schedule 6 of the ITA:

"28. (1) 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."

¹ Seah Eu Hen, 'RM33.8 bil wiped off market cap in knee-jerk reaction to 'cukai makmur' proposal' (The Edge Markets, 1 November 2021) <https://www.theedgemarkets.com/article/rm338-bil-wiped-market-cap-kneejerk-reaction-cukai-makmur-proposal>; Yen Nee Lee, 'Malaysia stocks fall 2% as government announces 'windfall' tax on companies' (CNBC, 1 November 2021) <https://www.cnbc.com/2021/11/01/malaysia-stocks-fall-as-government-announces-windfall-tax-on-companies.html>

As noted in Budget 2022, the introduction of this exemption was meant to encourage the remittance of foreign source income back into Malaysia for investment.

A ‘knee-jerk’ reaction?

Presumably, such investment has not suddenly become undesirable to Malaysia from an economic perspective, but rather must be balanced against other recent countervailing considerations.

On 5 October 2021, the European Union (EU) Council identified Malaysia as having a “harmful” exemption regime for foreign source income. Subsequently, Malaysia was added to Annex II of the EU List (**Grey List**). This may have prompted the government to consider removing this exemption to bring Malaysia in line with “best practices in taxation at the international level” (*“selaras dengan komitmen Malaysia terhadap pematuhan amalan terbaik percukaian di peringkat antarabangsa”*). Some have questioned whether this proposal is a “knee-jerk” reaction which ought perhaps to be reconsidered.²

Some considerations

From a legal point of view, the removal of this exemption can be achieved via removal of paragraph 28, Schedule 6 of the ITA through an amendment Act (often through the new Finance Act). Apart from this, however, many uncertainties and difficulties remain.

1) Income or capital?

“Income tax, if I may be pardoned for saying so, is a tax on income”.³ In other words, capital gains remain outside the charge of income tax under the ITA. Taxpayers who are contemplating the remittance of funds back into Malaysia may face difficulties in determining (much less proving to the Inland Revenue Board (**IRB**)’s satisfaction) the correct identity of such funds. This is especially for taxpayers who have maintained funds overseas for many years now.

2) Inconsistency in treatment with local types of income?

The proposal to remove this exemption is said to be for the provision of equality in tax treatment between foreign source income and income accrued in or arising from Malaysia (*“memberikan layanan cukai sama rata dengan pendapatan yang terakhir di Malaysia atau terbit dari Malaysia”*).

² Shazni Ong, ‘Proposal to remove foreign source income exemption comes as a surprise, says tax expert’ (The Edge Markets, 1 November 2021) <https://www.theedgemarkets.com/article/proposal-remove-foreign-source-income-exemption-comes-surprise-says-tax-expert>

³ Per Lord Macnaghten at the House of Lords in *The London County Council and others v The Attorney-General* [1901] AC 26

However, the opposite outcome may arise at least in respect of particular types of income. For instance, dividend income paid by Malaysian companies is currently exempt in the hands of shareholders. Unless specifically provided to the contrary, the removal of the exemption would result in foreign dividend income being taxable when remitted back to Malaysia, whereas local dividend income would not.

3) Retrospectivity and impact on foreign income earned but not previously remitted?

It is trite that statutes are *prima facie* prospective and not to be read retrospectively, unless explicitly stated otherwise.⁴ A vested right acquired under a statute (such as an exemption from tax) cannot be taken away unless this is expressed in the new law.⁵ It is clear, therefore, that foreign source income previously remitted back to Malaysia cannot be taxed by the IRB after the exemption is removed.

What remains less clear is whether foreign income that a taxpayer has previously earned, but not remitted back to Malaysia, can subsequently be taxed upon its remittance back to Malaysia after the exemption is removed.

E.g.

The taxpayer receives foreign source income paid to his overseas bank account in the years of assessment (“YAs”) 2010 to 2020 but did not remit them back to Malaysia. Effective 1 Jan 2022, the para 28, Schedule 6 ITA exemption is removed. On 1 Feb 2022, the taxpayer remits these funds back to Malaysia.

Are such funds taxable in Malaysia in YA 2022? On one hand, they are funds received in Malaysia from outside Malaysia in YA 2022. On the other hand, they were income in YAs 2010 to 2020 (when the exemption remained valid), and not arguably in YA 2022.

4) Double taxation and tax credits?

Another complication with the removal of this exemption is the possibility of double taxation. If the foreign-sourced income has already been subjected to tax in another jurisdiction, tax relief should be allowed on such funds upon their remittance to Malaysia. This is available in the form of bilateral tax credits (under agreements for the avoidance of double taxation (**DTAs**), or unilateral tax credits (in respect of income received from a country with whom Malaysia has not signed a DTA).

Again, determining the correct amount of bilateral/unilateral credits to be claimed and the amount of tax which has been paid by the taxpayer in the foreign jurisdiction may prove

⁴ *Kerajaan Malaysia v Rohana Abu* [2018] 9 CLJ 335; *PP v Datuk Haji Harun Hj Idris* [1977] 1 MLJ 14

⁵ *Society of La Salle Brothers v KPHDN* [2018] 8 CLJ 298; *National Land Finance Co-operative Society Ltd v DGIR* [1993] 4 CLJ 339; *Keith Sellar v Lee Kwang and Tennakoon v Lee Kwang* [1980] 2 MLJ 191

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difficult in practice, especially for taxpayers who have had funds in various jurisdictions for many years.

Concluding thoughts

In theory, the removal of the exemption on foreign source income should create a hitherto untapped source of additional revenue. In practice, it remains to be seen whether the benefits will outweigh the costs. Taxpayers with funds overseas may become understandably reluctant to repatriate funds back into the country considering the various uncertainties discussed briefly above.

It is imperative that our tax reforms be in line with the overall economic and financial goals of the country, especially in a time when international economies are grievously hit by the pandemic. The Malaysian tax system should remain simple, easy to comply with and competitive to maintain its attractiveness for foreign investments and taxpayers' confidence. Such objectives should stand alongside our commitment to adhere to international best practices in taxation matters

We will continue to monitor the developments on this issue carefully and provide further updates as and when they become necessary.

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