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Taxation Of Foreign Source Income

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In Malaysia, income tax is charged on income accruing in, derived from or received in the country as prescribed under Section 3 of the Income Tax Act 1967 (ITA). Section 127(1) of the ITA states that certain types of income specified in Part I of Schedule 6 such as foreign source income is exempt from tax (see paragraph 28 of Schedule 6 of the ITA). Recently, the Finance Act 2021, which is operative from 1.1.2022, amended paragraph 28 of Schedule 6 to restrict the tax exemption to only foreign source income received by non-residents in Malaysia.

Background

The law on foreign source income until 31.12.2021 provided a wider tax exemption where it also included individuals. Prior to 1.2.2022, paragraph 28 of Schedule 6 read:

“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.

(2) Paragraphs 5 and 6 of Schedule 7A shall apply mutatis mutandis to the amount of income derived and received by a resident company exempted under subparagraph (1).”

The new paragraph 28 of Schedule 6 introduced via Section 27 of the Finance Act 2021 reads as follows:

“28. The income arising from sources outside Malaysia and received in Malaysia by any person who is not resident in Malaysia.”

The amendment now restricts the tax exemption to foreign source income received by only non-residents in Malaysia.

On 16.11.2021, the Inland Revenue Board (IRB) announced a Special Income Remittance Programme (PKPP) in response

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to this amendment. The foreign source income remitted during the PKPP period of 1.1.2022 to 30.6.2022 will be taxed at 3% subject to certain terms and conditions. The IRB has stated that it will accept foreign source income submitted under the PKPP in good faith and as such, the IRB will not conduct further tax audit on such remittance.

However, on 30.12.2021, the Ministry of Finance announced a concession namely, income tax exemption on foreign source dividends will continue to be given to companies or limited liability partnerships while individuals will be tax-exempted for all types of income. This concession is subject to the guidelines which will be issued by the IRB.

The Law - Source Of Income

Section 12(1) of the ITA states that so much of the gross income as is not attributable to the operations of a business outside Malaysia shall be deemed to be derived from Malaysia. Nevertheless, 'source' is not defined in the ITA. Hence, case law principles will act as guidance to determine the source of income.

Guidance to determine the source of income was examined by the Privy Council in *Commissioner of Inland Revenue v Hang Seng Bank Ltd* [1991] 1 AC 306. In this case, a Hong Kong-based taxpayer bank invested in Singapore and London market certificates of deposit, bonds, and gilt-edged assets. These certificates were kept in an offshore bank until they could be sold for a profit. The question was whether the proceeds from the sale of those certificates were taxable in Hong Kong.

The Privy Council dismissed the Hong Kong tax authority's contention that the income was earned in Hong Kong since the bank's operations were solely conducted there. It was established in this case that *"the question whether the gross profit resulting from a particular transaction arose in or derived from one place or another is always in the last analysis, a question of fact, depending on the nature of the transaction"*.

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In summary, the test or better known as the Broad Guiding Principle to determine the 'source' of income is:

- (a) What has the taxpayer done to earn the profit in question.
- (b) Where did the transaction that produced the profit to the taxpayer take place?

Applying The Broad Guiding Principle In Malaysian Cases

The principle in the *Hang Seng* case on the question of foreign sourced income have been extensively relied on in Malaysian courts, for example in:

- (a) ***Aneka Jasaramai Express Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* [2001] 1 LNS 166**

The Special Commissioners of Income Tax (SCIT) held that the taxpayer's income from the sale of bus tickets in Singapore is not income accrued in or derived from Malaysia. As held by the High Court, *the sale of tickets took place in Singapore. The contract was entered in Singapore. The money was received in Singapore*".

- (b) ***Ketua Pengarah Hasil Dalam Negeri v Cardinal Health Malaysia 211 Sdn Bhd* [2011] 3 CLJ 196**

The Malaysian company invested surplus cash, including income from its Malaysian operation, in Allegiance Netherlands (a Dutch company within the same business group as the taxpayer) through loans advanced to the latter. The question was whether the Malaysian company's income in the form of interest payments was considered foreign source income.

Essentially, even if the monies were kept in Malaysia, the issue to determine is 'what the taxpayer has done to gain the profit', which in this case was the supply of loans to Allegiance Netherlands, a Dutch firm company based in the Netherlands (i.e. the source of income).

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(c) *Kyros International Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri (2013) MSTC 30-056*

In this case, franchise agreements were engaged by the taxpayer to provide franchisees (kebab fast food chain) the sole and exclusive right to create and operate in a specified location, including overseas. The granted right encompasses the Kyro's trademark and operating system. The Court of Appeal here upheld the SCIT's finding that the franchise fees overseas were received from overseas as all activities in respect of the franchising agreements were taken place overseas.

Conclusion

In essence, the source of profit and the location of a business are distinct from each other. In addition to satisfying the Broad Guiding Principle to determine a company's source of income, taxpayers in Malaysia should also take into account the implications of the new Finance Act 2021 which is more restrictive - where only non-residents are exempted in relation to foreign source income under the newly amended paragraph 28 of Schedule 6.

Authored by Rashmika Krishnamoorthy, an associate with the firm's Tax, SST & Customs practice.

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