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OUTCOME OF PROCEEDINGS

From: General Secretariat of the Council
To: Code of Conduct Group (Business Taxation)
Subject: Malaysia's Foreign source income (FSIE) regime (MY015)
– Final description and assessment

STANDSTILL REVIEW PROCESS (SEPTEMBER 2021)

Malaysia committed to reform its FSIE regime within a timeline that will permit adoption of the necessary legislation by the end of 2022. Malaysia also committed not to availing of any grandfathering, as requested by the COCG.

The Code of Conduct Group meeting of 21 September 2021 acknowledged the commitment of Malaysia. This conclusion was endorsed by the ECOFIN Council on 5 October 2021.

Annex 1: Assessment of the MY015 regime

Assessment of the MY015 regime (standstill)

Assessment of FSIE regime

	1a	1b	2a	2b	3	4	5
Malaysia – Foreign Source Income Exemption	V	X	V	X	V	X	X

V: Harmful; X not harmful

Gateway criterion – Significantly lower level of taxation:

“Within the scope specified in paragraph A, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this code”

The general income tax rate for companies in Malaysia is:

- (i) 17% for companies with paid-up capital of MYR 2.5 million (EUR 0.53 million) or less and having annual sales of not more than RYM 50 million (EUR 10.42 million), or
- (ii) 24% for companies with paid-up capital of more than MYR 2.5 million or having annual sales of more than RYM 50 million (EUR 10.42 million) and for non-resident companies.

Under the Income Tax Act (ITA) 1967, certain types of foreign sourced income are tax exempt.

As the Code of Conduct looks at the effects that tax legislation may have on the location of business activities in general terms, a full tax exemption may be regarded as a reason for businesses to establish in one jurisdiction instead of another. In this sense, these provisions are relevant for the Code.

The Code of Conduct uses a broad term ('tax measures') to describe what should be assessed under its criteria. This definition is not limited to specific pieces of legislation nor does it define what is intended as a 'tax measure'. In the specific case of the measures of Malaysia's ITA, it is relevant to take into account the general tax system, in order to understand whether the legislation provides for a significantly lower level of taxation. This is the case here, as certain types of income with foreign source are exempted from tax.

The provisions are therefore potentially harmful and should be evaluated under the Code.

Criteria 1 and 2 – Targeting non-residents and Ring-fencing

“whether advantages are accorded only to non-residents or in respect of transactions carried out with non-residents”

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Under Section 3 of the ITA 1967, the general rule is that Malaysia levies tax on income accruing in or derived from, Malaysia and on income from outside Malaysia once this is remitted to Malaysia.

The origin of business income is defined in Section 12 of the ITA. According to ITA, gross income from the business that is not attributable to operations carried on outside Malaysia, shall be deemed to be derived from Malaysia. To determine whether an item of income is domestic or foreign, an assessment is made by the tax administration on a case-by-case basis. They also consider collectively certain facts and circumstances (i.e. place where the contracts are concluded, whether the proceeds of sales are received outside Malaysia, whether the services are rendered outside Malaysia, etc.). If a taxpayer claims to treat an item of income as foreign sourced, it is up to the taxpayer to substantiate the claim and prove that the income is attributable to operations of business carried on outside Malaysia.

Under Paragraph 28 Schedule 6 of the ITA, which was introduced in 2004, foreign-sourced income is not subject to tax in Malaysia. This tax exemption for foreign sourced income applies to all companies whether resident or not and to all income (whether active or passive), with an exception for income generated by resident companies in the field of banking, insurance or air transport. As a result, taxability of both active and passive income is determined based on whether this accrues in, or derived from, Malaysia.

Regarding the Labuan territory, the Labuan Business Activity Tax Act (LBATA) 1990 establishes a separate tax regime for business activities in the Labuan International Business and Financial Centre (IBFC). Pursuant to the amendment made under the Finance Act 2018 to the LBATA 1990, Labuan IBFC entities carrying out activities in Labuan are taxed at the rate of 3% of their net audited profits, provided that they meet the substantial requirements prescribed in the Act. Entities that undertake non-trading activities will not be subject to tax.

Both ITA and LBATA tax systems are exclusive. By default, Labuan entities are subject to tax rules provided for in the LBATA. While they can elect to be taxed under the ITA rules, this choice is irrevocable. This means that the tax exemption for foreign-sourced income under the ITA does not apply to Labuan entities subject to tax under the LBATA.

According to Malaysia:

- 815 companies claimed foreign-sourced income exemption in 2018, which represents 0.2% of the total number of companies incorporated and registered in Malaysia;
- out of these 815 companies, 118 earned exclusively foreign-sourced income;
- the exempted income amounted to 2.63% of total income generated by all companies incorporated and registered in Malaysia;

Based on the above, we propose a tick (“V” – harmful) for criterion 1.a and 2.a and a cross (“X” not harmful) for criterion 1.b and 2.b.

Criterion 3 – Substance:

“whether advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages”

Under Malaysia’s domestic framework, a company is deemed resident if its management and control are exercised in Malaysia. Besides this, there is no requirement for companies to evidence further economic substance.

Regarding foreign entities, Malaysia’s legal and regulatory framework provides for the possibility of setting up different types of entities and arrangements in the country. Subject to the Companies’ Commission of Malaysia (CCM), foreign entities are required to be registered¹.

Regarding the Labuan territory, which has a separate legal and regulatory framework in the field of business taxation (see above), all entities whether local or foreign have to meet the substance requirement under the Labuan Business Activity Tax 2018 (Amendment) and Regulations 2019.

Section 140 of ITA and Section 17D of LBATA grant a general power to the Director General (DG) of the Inland Revenue Board of Malaysia to stop tax avoidance schemes by disregarding certain transactions. The application of this provision is based on the facts of each case, when the DG has reason to believe that a transaction has the effect of altering the incidence of tax, of evading or avoiding tax or relieving from a tax liability. The effective implementation mechanics are done through the combination of supervisory and enforcement measures taken mainly by the CCM and the IRBM in Malaysia and LFSA in Labuan IBFC. These measures include preventive programmes, audits and inspections, enforcement and strike-offs of non-compliant entities.

While there are general anti-abuse rules (GAARs) in place in Malaysia, these are generic and not targeted at tackling the specific risks of double non-taxation and the lack of substantial activities linked to income exempted from tax in Malaysia. In addition, it remains uncertain how the above mentioned GAAR is applied in practice by the Inland Revenue Board.

In light of the above, we propose a tick (“V” – harmful) for criterion 3.

¹ See Guidelines for registration of foreign companies:

[https://www.ssm.com.my/Pages/Legal Framework/GUIDELINES/gl6 bi guidelines for registration of foreign company 201117 0.pdf](https://www.ssm.com.my/Pages/Legal%20Framework/GUIDELINES/gl6%20bi%20guidelines%20for%20registrati%20on%20of%20foreign%20company%20201117%200.pdf)

Criterion 4 – Internationally accepted principles:

“whether the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD”

The definition of Permanent Establishment (PE) is prescribed under Section 12 of ITA, which provides for a definition of a “place of business” in line with the OECD model. In addition, the PE definitions incorporated in Malaysia’s tax treaties are in general based on the OECD Model Tax Convention and/or the UN Model Tax Convention.

Malaysia ratified the OECD Multilateral Instrument (MLI), which will enter into force on 1st June 2021.

In light of the above, we propose a cross (“X” – not harmful) for criterion 4.

Criterion 5 – Transparency:

“whether the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way”

All conditions necessary for granting the tax benefits under the FSIE regime in Malaysia are clearly laid down in the legislation, either ITA or LBATA.

Therefore, we propose a cross (“X” – not harmful) for criterion 5.

Overall assessment

In light of the analysis above, Malaysia’s FSIE regime is considered overall harmful.