Tax Legislation and Issues on Islamic Financing

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Agenda

• Introduction
• Malaysian tax legislation
• 2007 – Incentives for Islamic Finance
• Examples
Introduction
Introduction

- Malaysian Government has been promoting Islamic Banking and Finance in Malaysia

- Certain tax exemptions have been provided and these have been refined over the years

- The recent 2007 Budget provided further tax incentives to Islamic Finance
Introduction

Conventional Financing compared to Islamic Financing

Conventional financing arrangement

* Minimal tax implications apart from determining the tax deductibility of coupons / interest and issuance costs
Conventional compared to Islamic Financing (contd’)

Islamic financing arrangement

Customer/Issuer

(1) Sale of asset
(2) Asset repurchase / Ijarah (Lease)
(2) Securities issuance

Financiers

(1) Funds

* More complex tax considerations depending on the Islamic structure as there is an underlying disposal of asset and repurchase of asset / Lease
Malaysian Tax Legislation
Malaysian tax legislation

- In order to provide tax neutrality to Islamic funding transactions, the Malaysian tax legislation has certain clauses specifically on Syariah based transactions.
- The main sections in the Income Tax Act, 1967 are Section 2(7) and Section 2(8).
- RPGT and stamp duty exemptions have also been provided to facilitate Syariah financing transactions.
Malaysian Tax Legislation

Income Tax Act, 1967 (“ITA”)

Section 2(7)

- Any reference in the ITA to interest shall:
  “……apply, mutatis mutandis to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of *Syariah*”

a) Since interest is not allowed under Syari’ah principles, Islamic financing transactions would have a “profit” element instead.

b) The Malaysian Income Tax Legislation treats “profits” in Islamic transactions to be similar to interest – Sec. 2(7)

c) Therefore, the taxability or deductibility of “profits” would be similar to the treatment of “interest” in a conventional financing arrangement
Malaysian Tax Legislation (contd’)

Analysis of Section 2(7)

a) “Profit” treated as interest and therefore, tax deductible if funding has been used for business purposes or to purchase assets to generate income

b) All tax rules relating to “interest”, such as interest withholding tax and exemptions will equally apply on the “profit”
Any reference in the ITA to the disposal of an asset or a lease shall:

“exclude any disposal of an asset or lease by or to a person pursuant to a scheme of financing approved by the Central Bank, the Securities Commission or LOFSA, as a scheme which is in accordance with the principles of Syariah where such disposal is strictly required for the purposes of complying with those principles but which will not be required in any other schemes of financing”
Malaysian Tax Legislation (cont’d)

Analysis of Section 2(8)

* Section 2(8) seeks to ignore the underlying transaction so that tax neutrality can be achieved in Islamic funding transactions
Malaysian Tax Legislation (cont’d)

Real Property Gains Tax Act, 1976 ("RPGT Act")

Sch 2, Para 3(g) (amended)

“the disposal of any chargeable assets pursuant to a scheme of financing approved by the Central Bank; or the Securities Commission as a scheme which is in accordance with the principles of Syariah, where such disposal is strictly required for the purpose of compliance with those principles but which will not be required for any other schemes of financing”

RPGT (Exemption) Order No. 3, 2003

Exempts any person from payment of RPGT in respect of chargeable gains accruing on the disposal of any chargeable assets in relation to the issuance of PDS under Islamic principles.
Exempts any person from the payment of RPGT in respect of chargeable gains accruing on the disposal of any chargeable assets –
   a) to or in favour of a special purpose vehicle; or
   b) in connection with the repurchase of the chargeable assets, to or in favour of the person from whom those assets were acquired, for the purpose of securitization transaction.
Malaysian Tax Legislation (contd’)

Stamp Act 1949 (‘Stamp Act’)

First Schedule of the Stamp Act – insertion of a new paragraph under “GENERAL EXEMPTIONS”

- An instrument executed pursuant to a scheme of financing approved by the Central Bank or the Securities Commission as a scheme which is in accordance with the principles of Syariah, where such instrument is an additional instrument strictly required for the purpose of compliance with those principles but which will not be required for any other schemes of financing.

Various Stamp Duty Exemption Orders

- Various exemptions have been provided on purchase of property by any financier for the purpose of resale under the principles of Syariah as well as Ijarah transactions.
Malaysian Tax Legislation (contd’)

<table>
<thead>
<tr>
<th>Income Tax Act, 1967 (“ITA”)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income Tax (Deduction for expenditure on issuance of Islamic securities) Rules 2005</td>
</tr>
<tr>
<td>• Provides for tax deduction in respect of expenses incurred on issuance of Islamic securities which adopt the principles of <em>mudharabah</em>, <em>musyarakah</em> and <em>ijarah</em> from 3 July 2004 to the year of assessment 2007</td>
</tr>
<tr>
<td>Income Tax (Deduction for expenditure on issuance of Islamic securities pursuant to Istisna’ principle) Rules 2005</td>
</tr>
<tr>
<td>• Provides for tax deduction in respect of expenses incurred on issuance of Islamic securities based on <em>istisna’</em> from 3 July 2004 to the year of assessment 2007</td>
</tr>
</tbody>
</table>

• Therefore, issuance costs of Islamic Bonds based on principles of *mudharabah*, *musyarakah*, *Ijarah* and *Istisna’* will be tax deductible from 3 July 2004 to year of assessment 2007
2007 Budget Incentives – Islamic finance
Incentives

Islamic Finance

- Substantial tax incentives have been provided to Financial Services sector
- Most of the tax incentives are towards the development of Malaysia as an International Islamic Financial Centre
- Tax incentives can be broadly categorised into the following areas:
  a) Islamic Banking and Takaful
  b) Fund Management
  c) Capital markets
  d) Human capital and others
Incentives

a) Islamic Banking and Takaful

Islamic Banking and Takaful
1. Income tax exemption for Islamic Banking and Takaful business
2. Tax exemption – Profits paid by Islamic Banks to non-residents
3. Tax neutrality of Islamic financing transactions – Musyarakah financing not required to file partnership tax returns
Incentives – Islamic Banking and Takaful

1. Income Tax Exemption for Islamic Banking and Takaful Business

**Proposed**

Income tax exemption for 10 years:
- Islamic banks / units licensed under Islamic Banking Act 1983 on income derived from Islamic banking business conducted in international currencies, including transactions with Malaysian residents
- Takaful companies/ units licensed under Takaful Act 1984 on income derived from Takaful business conducted in international currencies, including transactions with Malaysian residents

**Effective from YA 2007 to YA 2016**
(Awaiting PU Order)
Incentives – Islamic Banking and Takaful

2. Tax exemption – Profits paid by Islamic Banks to non-residents

Current

- Banks licensed under BAFIA
- Islamic window

Interest

Exempted from tax

Non-resident customers

Profit

Paragraph 33 Schedule 6 provides that interest income received by non-residents from banking and financial institutions established under Banking and Financial Institutions Act, 1989 is exempted from tax.

Proposed

- Banking and financial institutions established under Islamic Banking Act, 1983
- Other financial institutions approved by the Ministry of Finance

Profits in lieu of interest income received by non-residents

Exempted from tax

Stream line tax treatment on profits “interest received from Islamic banks and conventional banks

Effective from 2/9/2006

(Amendments made to Schedule 6 Paragraph 33)
3. Tax neutrality– Musyarakah financing

• Currently, definition of “partnership” includes all types of partnership, the only exception being a Hindu joint family

• Proposed:
  Definition amended to exclude “any association which is established pursuant to a scheme of financing in accordance with the principles of Syariah”

• Provide tax neutrality to Islamic financing structures based on the concept of Musyarakah

• No separate partnership tax return is required to be submitted

**Effective from YA 2007**
(Amendment to Section 2)
Incentives

b) Fund Management

1. Tax exemption for companies managing foreign Islamic funds

2. REITs - Tax transparency system refined further

3. REITs investors – reduction in tax rates
1. Tax exemption for companies managing foreign Islamic funds

Current

• Local and foreign companies licensed by the Securities Commission (“SC”) under the Approved Foreign Fund Management status and managing foreign investors’ funds are taxed at 10% on fees received from foreign investors

Proposed

• Local and foreign companies managing funds of foreign investors established under Shariah principles be given full tax exemption on management fees for 10 years
• Fund must be approved by SC

Clarification required:
What has been defined as “funds of foreign investors”?

Effective from YA 2007 to YA 2016
(Awaiting exemption order)
2. REITs - Tax transparency system refined further

**Income Not Distributed:**
- Continue to be taxed 28% at REIT level

**Income Distributed:**
- Income distributed will not be taxed at REIT level
- Instead, investors will be taxed on the income distributed based on their marginal rates of tax
- Withholding tax of 28% on distributions to non-resident investors
2. REITs - Tax transparency system refined further (cont’d)

Incentives – Fund Management

Proposed

Approved REITs

Distributes at least 90% of income

- REITs will be exempted from tax on all income

Effective from YA 2007

Approved REITs

Distributes less than 90% of income

- REITs will be subject to income tax on chargeable income at normal corporate income tax (e.g. 28%)
- Investors will be entitled to tax credit on tax already paid by REITs
Incentives – Fund Management

3. REITs investors – Reduction in tax rates

<table>
<thead>
<tr>
<th>REIT Distributions</th>
<th>Current tax treatment</th>
<th>Proposed tax treatment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals &amp; Non-corporate Investors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Resident</td>
<td>Taxed at own marginal rate of tax</td>
<td>Withholding tax of 15%</td>
</tr>
<tr>
<td>Non-resident</td>
<td>Withholding tax of 28%</td>
<td>Withholding tax of 15%</td>
</tr>
<tr>
<td>Corporate Investors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Resident</td>
<td>Taxed at normal corporate tax rate (28% currently)</td>
<td>Existing tax treatment (27% effective YA 2007)</td>
</tr>
<tr>
<td>Non-resident</td>
<td>Withholding tax at 28%</td>
<td>Existing tax treatment (27% withholding tax from 1.1.2007)</td>
</tr>
<tr>
<td>Institutional investors*</td>
<td>Foreign</td>
<td>Withholding tax at 28%</td>
</tr>
</tbody>
</table>

*Institutional investors
- pension fund, collective investment scheme or such other person approved by the Minister

Effective from 1/1/2007 (5 year tax incentive)
(Amendments to tax act)
c) Islamic capital market

1. Expenses to establish Islamic stock broking companies
2. Extension of tax incentive for issuance of Islamic securities
3. Tax treatment of SPV for Islamic financing
4. Profits on foreign currency bonds
1. Tax deduction on expenses to establish Islamic stock broking companies

**Tax incentive**

- Pre-commencement expenses are generally not deductible (except for certain incorporation expenses).
- Islamic stock broking company - A tax deduction allowed equivalent to the establishment expenses incurred

**Establishment expenses**

- Consultancy
- Legal fees
- Cost of feasibility study
- Cost of market research
- Cost of obtaining license and business approval

- Applications received by SC from 2/9/2006 until 31/12/2009
- Company must commence business within 2 years from date of approval from the SC (PU Order gazetted)
2. Extension of tax incentive for issuance of Islamic securities

- Expenses incurred on issuance of Islamic securities extended to another 3 years to 2010
- Incentive will also be given to all Islamic securities products approved by the Securities Commission

Issuance of bonds based on:

- *Ijarah*
- *Istisna’*
- *Mudharabah*
- *Musyarakah*

Others approved by SC (including Al-Bai Bithaman Ajil and Murabahah ?)

- Tax deduction of issuance costs up to 2010
- Tax deduction of issuance costs from YA 2008 to 2010
3. Tax treatment of special purpose vehicle (“SPV”) for Islamic financing

Example of Islamic bond issuance

- Under Islamic financing transactions, SPV is set up purely to channel funds and facilitate issuance of Islamic bonds/ funding
- Currently, SPV is subject to income tax and administrative requirements under Income Tax Act, 1967 (“ITA”)
- SPV not subject to income tax and not required to comply with ITA administrative requirements. Certain conditions and clarification required.

Effective from YA 2007
4. Tax exemption – Profits on foreign currency bonds

**Current**

- Bonds in Ringgit
- Exempted from tax
- Interest
- Profit
- Non-resident customers

**Recent announcement**

- Bonds in foreign currency
- To be exempted and not subject to withholding tax

Interest or profits on Ringgit bonds approved by the Securities Commission is not subject to withholding tax.
Incentives

d) Human capital and others

1. Tax relief for individuals on Islamic Finance courses

2. Additional 20% stamp duty exemption on Islamic Financial instruments

3. Stamp duty exemption for loans to SMEs
1. Tax relief for individuals on Islamic Finance courses

**Current**

- Relief of up to RM5,000 per annum for fees paid for certain courses at local institution of higher education
  
  (i.e. science, technical, vocational, industrial skills development, information and communication technology, accountancy and law)

**Proposed**

- Relief extended to courses in Islamic finance approved by Bank Negara Malaysia or Securities Commission at local institutions of higher education, including at the International Centre for Education in Islamic Finance ("INCEIF")

Effective from YA 2007
2. Additional 20% Stamp duty exemption on Islamic Instruments

**Stamp Duty (Remission)(No.2) Order 2007**

- **Additional 20% stamp duty exemption** is given on instruments used in Islamic financing
  
  - Instrument has to be approved by Bank Negara Malaysia Syariah Advisory Council or Securities Commission

**Effective from 2/9/2006 to 31/12/2009**

**Recent announcement**

- 100% stamp duty exemption for 10 years on foreign currency instruments executed by Islamic financial institutions and on instruments relating to Ringgit as well as foreign currency Islamic securities.
Examples
Example 1

**Al-Bai Bithaman Ajil ("ABBA")**

Sale and purchase transaction for the financing of an asset on a deferred payment basis with a pre-agreed payment period. The sale price will include a profit margin. Essentially a sale and buyback arrangement.

1. Issuer sells assets to financiers
2. Issuer purchases the same assets from financiers at a marked-up price

Issues ABBA bonds with obligation to pay financiers the purchase amount.

**Issuer**

**Malaysian Bank / SPV**

Proceeds
Example 1 – ABBA (contd’)

Malaysian Tax considerations based on current rules

• Based on Section 2(8) of the ITA, the disposal of the asset will be disregarded for income tax purposes

• So, there should not be any RPGT or income tax impact on the disposal of properties or assets

• Stamp duty exemption will mean that no additional stamp duty will be applicable compared to a conventional transaction

• Based on Section 2(7), the profit element will be treated as “interest” for tax purposes. Tax deductibility therefore available depending on usage of funds

• Issuance cost **not** tax deductible since bond has not been issued based on
  
  *mudharabah*, *musyarakah*, *ijarah* or *istikna*
Example 2

*Ijarah*

A contract for the sale of benefits and services between the owner of the assets ("lessor") and the user of those same assets ("lessee") at an agreed price.

1. Sale of assets/properties
2. Leaseback assets in return for Al-Ijarah rental stream
3. Issue Sukuk Al-Ijarah Bonds

Issuer

Malaysian Bank / SPV

Investors
Example 2 – Ijarah (contd’)

Tax considerations

• Disposal of the assets is disregarded for the purpose of income tax based on Section 2(8) of the ITA
• No RPGT impact on the disposal of properties
• No additional stamp duty will be applicable compared to a conventional transaction
• Based on Section 2(7), the profit element will be treated as “interest” for tax purposes
• Still need to consider impact of Income Tax Leasing Regulations (if any)
• Taxation of SPV needs to be considered
• Issuance cost will be tax deductible since bond has been issued based on *Ijarah*
Example 3

Acquisition and holding of vehicles as inventory

- Islamic bank
- Customer

Ijarah

Purchase vehicle and hold as inventory

Sell or lease motor vehicles

Some Islamic banking products include the Islamic bank entering into arrangements where the asset is owned by the Islamic Bank legally.

Tax considerations

- Would Income Tax Leasing Regulations (ITLR) apply to the Islamic Bank?
- Leasing income treated as separate source of the Islamic Bank
- Common expenses and funding costs need to be segregated based on a formula
- Capital allowances quarantined to leasing source
- Could increase effective tax rate
Example 4

Musyarakah arrangements

- Islamic bank enters into “partnership” with customer in order to fund an acquisition or project
- Effective YA 2007, no need to file separate partnership tax return
- Islamic Bank will be taxed on returns from Musyarakah

- Investments in various sectors (e.g. halal food, plantations, etc.)
- Project financing
Example 5 – Case study

**Foreign Ijarah**

A contract for the sale of benefits and services between the owner of the assets (“lessor”) and the user of those same assets (“lessee”) at an agreed price

1. Sale of assets/properties
2. Leaseback assets in return for Al-Ijarah rental stream
3. Issue Sukuk Al-Ijarah Bonds

How would this transaction be treated for tax purposes?
Example 5 – Foreign Ijarah (cont’d)

Questions

• How would disposal be treated for tax purposes?
• Any income tax or RPGT impact?
• Tax deductibility of funding costs? Withholding tax impact?
• Issuance costs tax deductible?