

Budget 2007: A boost for Islamic Banks

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Substantial tax incentives have been proposed in Islamic finance during the recent Budget 2007 announcement. This is not surprising as the global market is experiencing an inflow of investors from the Middle East seeking modes of financing and investments, which not only provide similar returns compared to conventional financing and investments but are also in compliance with Islamic religious principles.

Such investors from the Middle East are eyeing Asia for investment potential, especially with the rise of economies such as China and India. As the demand for Islamic financing products grows globally, more and more countries are realising the potential of Islamic finance, which is likely to experience substantial growth worldwide.

Malaysia has many years of experience in Islamic banking, *takaful* (insurance) and capital markets. It is, therefore, appropriate for Malaysian players to capitalise on this market niche.

In seeking to promote Malaysia as an International Islamic Financial Centre (IIFC), tax incentives have been proposed to attract foreign Islamic finance players to establish themselves in Malaysia, grow the market as well as encourage Malaysian players to innovate and seek new markets to export their expertise.

Some of the more substantial tax incentives announced which have an impact on Islamic finance are highlighted below.

Islamic banking — tax exemption

Islamic banking showed commendable growth in 2005, with profitability and assets surpassing for the first time the RM1 billion and RM100 billion thresholds respectively. Bank Negara Malaysia (BNM) has also issued three new Islamic banking licences to foreign Islamic financial institutions from the Middle East, namely Al Rajhi Banking and Investment Corporation, Kuwait Finance House (Malaysia) Bhd and a consortium of Islamic financial institutions led by Qatar Islamic Bank (inclusive of Qatar Islamic Bank 70%, RUSD Islamic Bank Inc 20% and Global Islamic House 10%).

Currently, banks in Malaysia are taxed normally at 28% (rate to be reduced to 27% with effect from year of assessment 2007) and on a worldwide basis. This means that a licensed bank in Malaysia will be subject to Malaysian income tax on income received from overseas, including the income of the foreign branches of the Malaysian bank.

Under Budget 2007, a 10-year tax exemption is to be provided to Islamic banks and Islamic banking units licensed under the Islamic Banking Act 1983 on income derived from Islamic banking business conducted in international currencies, including transactions with Malaysian residents. This incentive is effective from year of assessment 2007.

What this means is that the income received by an Islamic bank from transactions in foreign currencies with foreign parties as well as Malaysians will be tax-free until year of assessment 2016.

The 10-year tax exemption will certainly provide a boost to the activities of existing Islamic banks in Malaysia. It will hopefully also attract foreign Islamic financial institutions to locate themselves in Malaysia and use Malaysia as their International Islamic Centre in this region.

Based on the announcements, it appears that the 10-year tax exemption applies only to Islamic banks licensed under the Islamic Banking Act, 1983. Conventional banks which have Islamic banking windows may not be able to enjoy the benefit of this tax exemption. However, the legislation for this tax exemption has not been issued and would need to be analysed in more depth when gazetted.

Promotion of Malaysian Islamic banks to foreigners

It is important to note that under syariah principles, interest is prohibited as it is seen to be usury. Instead, Islamic banks will normally share profits with their customers depending on the financing products offered.

Section 2(7) of the Income Tax Act, 1967 (ITA) provides for the tax treatment of profits from syariah products to be similar to interest under conventional financing products. This means that profits received by the Islamic bank on Islamic financing provided to customers will be taxed just like interest income. Customers receiving profits from Islamic banks will also be treated to have received interest for tax purposes and taxed accordingly.

Normally, withholding tax of 15% would apply when a Malaysian resident pays interest to a non-resident. Conventional banks are specifically not required to withhold the tax under specific tax exemption.

In complementing the tax exemption provided to Islamic banks, it was proposed in Budget 2007 that the profits paid by Islamic banks to foreign customers are also not subject to income tax or withholding tax.

Tax neutrality of Islamic financing products

Generally, most Islamic financing products offered in the market require assets to be the underlying transaction. This could involve an Islamic bank purchasing a property for resale to the customer who will then repay the Islamic bank over the term of the financing.

Section 2(8) of the ITA provides for tax neutrality of Islamic financing transactions by providing that:

"...any reference in this Act 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 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 complying with those principles but which will not be required in any other schemes of financing."

To ensure tax neutrality (for example, disregarding underlying purchase of assets for resale), it is important that approval from Bank Negara for the financing product is obtained to confirm that that scheme of financing is strictly required for syariah purposes.

Similar tax neutrality paragraphs have also been provided for Real Property Gains Tax and stamp duty to facilitate Islamic financing transactions.

It is, however, important to note that with the rise in innovation and newer products being offered by Islamic bankers, each specific financing product has to be analysed to ensure that the tax neutrality provisions cater for such newer financing products.

A case in point is the introduction of Musyarakah financing products.

Currently, the definition of partnership for tax purpose is very wide and includes all types of partnership with certain exclusion. Based on this definition, it would appear that the Musyarakah or "partnership" between the Islamic bank and the customer would need to file a tax return. Multiply this by the number of customers of the Islamic bank and we can see that this will be an administrative burden which adds to the costs of the financing.

As part of Budget 2007 initiatives, the Finance Bill 2006 amends the definition of "partnership" for the purposes of tax to exclude any association which is established pursuant to a scheme of financing in accordance with the principles of syariah. This means that such financing products would not require the filing of separate tax returns.

Cheaper funding costs

Budget 2007 also saw the reduction of stamp duty for Islamic financing products.

Firstly, it was announced that 20% stamp duty exemption be given on instruments used in Islamic financing for three years. This exemption will be provided after the stamp duty is exempted for purpose of tax neutrality. What this appears to mean is that stamp duty payable under Islamic financing will be 20% less than conventional financing. This incentive is from Sept 2, 2006 to Dec 31, 2009 subject to the condition that the Islamic financial products are approved by the Bank Negara Syariah Advisory Council or Securities Commission Syariah Advisory Council.

Conclusion

The tax incentives highlighted are only the main announcements made on Islamic banking. More tax goodies have also been proposed for other areas such as Islamic Capital Markets, Islamic Fund Management and Takaful.

With the globalisation of the financial markets, Malaysia needs to develop a competitive edge by positioning itself as a viable and vibrant International Centre for Islamic Finance. Budget 2007 provides the platform for Islamic finance players to compete in this arena and it is hoped that the government's vision will be successfully realised.

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