

The 2007 Malaysian Budget announced on 1 September 2006, provides substantial tax incentives to boost the Islamic Finance sector.

IN LINE WITH THE MALAYSIAN GOVERNMENT'S EFFORTS TO PROMOTE MALAYSIA AS AN ISLAMIC FINANCIAL CENTRE ("MIFC"), THE 2007 BUDGET ANNOUNCEMENTS ON 1 SEPTEMBER 2006 PROVIDED SUBSTANTIAL TAX INCENTIVES IN THE AREA OF ISLAMIC FINANCE. The new incentives are opportune to capitalise on an influx of liquidity, particularly from the Middle East. Middle Eastern investors are looking into modes of financing and investments that not only provide similar returns compared to conventional financing and investments but are also in compliance with Islamic religious principles.

As the demand for Islamic financing products increases globally, more and more countries are realising the potential of Islamic finance. In seeking to develop this market niche, the Malaysian Government has provided numerous tax incentives to support regulatory policies in ensuring the country's role as a leading Islamic Financial Centre in the region.

Islamic Banking and Takaful Business

Islamic banking as a whole showed commendable growth in 2005, with profitability and assets surpassing for the first time the RM1 billion and RM100 billion thresholds respectively. The Islamic banking industry also welcomed foreign participants into its fold with the issuance of three new Islamic banking licences to foreign Islamic financial institutions from the Middle East.

Islamic insurance or takaful is also fast gaining attraction from Muslims because of their combination of financial efficacy and religious righteousness. As a track record, Malaysia is the forerunner in terms of takaful activities in the South East Asian region. Recently, Bank Negara Malaysia ("BNM") has granted 6 new Takaful licenses.

As part of the strategy to boost Malaysia as an MIFC, BNM had recently announced that foreign and local banks and takaful operators will be granted new conditional licences to undertake a full range of Islamic banking and takaful businesses in international currencies.

Complementing this regulatory policy, the 2007 Budget which was announced on 1 September 2006 proposed substantial tax incentives to boost the Islamic Banking and Takaful industry in Malaysia. Some of the more major tax incentives announced are in the following pages.

Islamic Banking and Takaful Business (cont'd)

1. Tax exemption of Islamic Banks and Takaful companies	<ul style="list-style-type: none">• 10 year tax exemption 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; and• 10 year tax exemption to Takaful companies and Takaful units licensed under the Takaful Act 1984 on income derived from Takaful business conducted in international currencies including transactions with Malaysian residents. <p>This incentive is effective from year of assessment 2007 to year of assessment 2016.</p>
2. Exemption from withholding tax	<p>Currently, Paragraph 33 of Schedule 6 of Income Tax Act, 1967 ("ITA") provides tax exemption on –</p> <ul style="list-style-type: none">• "Income of any person not resident in Malaysia for the basis year for a year of assessment, in respect of interest derived from Malaysia (other than such interest accruing to a place of business in Malaysia of such person) and paid or credited by any person (whether the same person or not) carrying on the business of banking or finance in Malaysia and licensed under the Banking and Financial Institutions Act".• Technically, this tax exemption would only apply to normal conventional banks and their Islamic windows, but not to Islamic Banks licensed under the Islamic Banking Act 1983 ("IBA").• To streamline tax treatment on profits received by foreign non-resident customers from all financial institutions, it was proposed that profits received by non-residents from financial institutions established under the Islamic Banking Act 1983, and other financial institutions approved by the Minister of Finance be exempt from tax as well.• It has also been confirmed by the 2007 Budget that any profits paid out by an Islamic bank to foreign non-resident customers need not be subject to tax in Malaysia, thus providing equal treatment with conventional bank foreign customers. This means that there will be no withholding tax on profit payments made by all licensed banks in Malaysia to non-resident customers. <p>This proposal is effective from 2 September 2006.</p>
3. Facilitation of financing transactions	<p>Currently, the definition of partnership for tax purpose is very wide and includes all types of partnerships. Hence, any type of partnership, unless specifically excluded, would have to file tax returns. Such tax treatment would not promote financing transactions such as Musyarakah or Mudharabah since it would technically mean that tax returns have to be submitted for each transaction.</p> <p>In recognising and promoting Islamic financing structures based on the concept of Musyarakah or Mudharabah, it has also been proposed that such financing transactions need not file partnership tax returns.</p> <p>The effective date is from year of assessment 2007.</p>

Fund and Fund Management

It is important to recognise the role of the fund manager in promoting and growing the fund management industry and attracting funds from customers. To this effect, the 2007 Budget provides the following:

1. Tax exemption of fund managers	<p>10 year tax exemption to local and foreign companies managing funds of foreign investors established under the Shariah principles and approved by the Securities Commission. This incentive is effective from year of assessment 2007 to year of assessment 2016.</p> <p>It is hoped that this tax incentive will attract Fund Managers to establish operations in Malaysia specifically for managing funds based on Shariah principles. If reputable Fund Managers set up in Malaysia, more Shariah funds and products will be created and marketed to foreign investors, making Malaysia the hub for attracting Shariah monies for reinvestment around the region.</p>
2. Real Estate Investment Trusts (“REITs”)	<p>REITs have also been provided with further boost through several tax initiatives announced -</p> <ul style="list-style-type: none">• So long as REITs distribute at least 90% of income to investors, the REITs will not have to pay tax.• Distributions to certain investors will be subject to reduced tax for 5 years, namely:<ul style="list-style-type: none">- Non-corporate investors, including resident and non-resident individuals, that receive dividends from REITs listed on the Bursa Malaysia be subject to a final withholding tax of 15%; and- Foreign institutional investors, especially pension funds and collective investment funds, that receive dividends from REITs listed on the Bursa Malaysia, be subject to a final withholding tax of 20%. <p>Corporate investors (resident and non-resident) will continue to be subject to normal corporate income tax at 28% (to be reduced to 27% from year of assessment 2007).</p>

Human Capital

In encouraging Malaysians to explore Islamic finance as a career choice, tax relief not exceeding RM5,000 per annum is also provided on Islamic finance courses approved by BNM or SC at local institutions.

The 2007 Budget has certainly provided the much needed fiscal incentives to spur the growth of Islamic finance in this region. With the stage all set, it is now up to the Government and the players to profile Malaysia internationally and position the country as an International Islamic Financial Centre.

Islamic Capital Market

The Islamic capital market has emerged as a significant area of growth in Malaysia as it represents a viable and competitive alternative to the conventional market. This is especially for investors who are inclined towards investing and utilising products that conform to Shariah principles.

The 2007 Budget announced several tax incentives including:

1. Tax treatment of special purpose vehicles (“SPV”) established solely for the purposes of issuance of Islamic bonds

Under Islamic financing transactions, an SPV is established purely to channel funds and facilitate the issuance of Islamic bonds or funding. Although the SPV is merely a “pass through” vehicle in substance, the SPV is still required to submit a tax return and comply with all the administrative requirements of the Malaysian tax legislation.

It is proposed that SPVs created specifically to facilitate the Islamic funding and is part of a scheme approved by Securities Commission (“SC”) be treated as “pass through” vehicles and are not required to comply with the administrative requirements under ITA. There are however certain requirements and conditions which need to be clarified.

This measure is effective from year of assessment 2007 onwards.

2. Extension of tax deduction on issuance costs of Islamic securities

Currently, expenses incurred on the issuance of Islamic securities based on leasing (Ijarah), progressive sales (Istisna’), profit sharing (Mudharabah) and profit and loss sharing (Musyarakah) are allowed as tax deduction.

These are provided in:

- Income Tax (Deduction for Expenditure on Issuance of Islamic Securities) Rules 2005; and
- Income Tax (Deduction for Expenditure on Issuance of Islamic securities pursuant to Istisna’ principle) Rules 2005.

These incentives will expire in year of assessment 2007.

To ensure Islamic securities continue to be competitive, it has been proposed that tax deduction on the expenses incurred on the issuance of Islamic securities based on Ijarah, Istisna’, Mudharabah and Musyarakah be extended another 3 years to 2010. These incentives will also be accorded to all Islamic securities products approved by the SC.

3. Others

Other tax initiatives include:

- Pre-commencement expenses of an Islamic stock broking business will be allowed as tax deduction so long as business is commenced within 2 years from approval by the SC.
- Further stamp duty exemption of 20% on instruments used in Islamic financing products approved by the Shariah Advisory Council of BNM or the SC for a period of 3 years. This means that Islamic transactions will suffer less stamp duty by 20% compared to conventional financing instruments.
- SPVs established solely for the purposes of issuance of Islamic bonds need not be subject to tax or tax administrative procedures.