CHARTERED TAX INSTITUTE OF MALAYSIA

MEMORANDUM ON CAPITAL MARKET INDUSTRY

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Memorandum on
Capital Market Industry (CMI)

Contents

A. GENERAL COMMENTS

1. Disparity in expectations between Budget announcement and implementation

There have been occasions where well conceived Budget proposals are subsequently watered down after the actual rules and regulations were introduced, thereby creating a disparity between expectations after the Budget announcement and the application of the law upon its implementation.

For instance, in Budget 2006, it was announced that the discount/premiums on bonds for financial institutions and non-financial institutions will be accorded equal tax treatment "*to encourage non-financial institutions to opt for the issuance of bonds as an alternate source of funding*". However, Section 34C which was introduced to implement the proposal does not give the equal treatment and in fact denied most of the non-financial institution issuers any deduction in practice!

Comments:

CTIM's view is that in the long run, such a situation may not enhance the credibility of the policy makers and the public will develop a wait-and-see attitude towards Government announcements. Accordingly, the actual rules and regulations introduced should be timely and in line with the intention of the Budget announcement.

2. Misalignment of the Announcement and Legislative Framework

At times, the relevant regulations and guidelines are not available for a long time, thereby rendering the incentives introduced ineffective. The following are a few examples.

It was announced in the 2004 Budget that in order to stimulate the capital market and diversify sources of financing for economic development, the Government intended to ensure neutrality in tax treatment between asset-backed securities and other securities approved by the Securities Commission. Until today, the **Income Tax (Asset-Backed Securitisation) Regulations** have not been issued.

In 2002, it was announced in the Budget speech that carried interest earned by a fund manager or manager be tax exempted. Since then, there has been no Gazette Order or confirmation that carried interest will be tax exempted.

Comments:

The common occurrence of the misalignment has a negative impact on Government initiatives in developing the capital market. The delay in issue of guidelines or regulations has rendered the proposed measures ineffective. It does not help to enhance the credibility of the policy makers in the long run. Such a situation may erode the public confidence towards Government announcements.

CTIM would like to urge the relevant authority to consult the stakeholders on a proposed measure and the relevant rules or regulations before it is announced to the public, and before the relevant rules or regulations are gazetted. This will give the industry players sufficient lead time to anticipate the changes, and also serve as advanced notice to the industry to ensure successful implementation.

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B. ISSUES RELATED TO LONG-TERM DEVELOPMENT OF CAPITAL MARKETS

1. Tax Deduction on Interest Expenses Incurred by Insurance Company/Takaful Operator

With the introduction of the Risk Based Capital ("RBC") Framework by Bank Negara Malaysia effective year 2009, insurance companies and takaful operators may wish to issue debt papers that qualify for capital treatment to maintain their capital adequacy ratios that commensurate with their risk profile for RBC purposes. However, sections 60 and 60AA of the Income Tax Act 1967 (ITA) do not prescribe any tax deduction by insurance companies / takaful operator on interest incurred/paid.

Comments:

The fundamental principle for tax deduction as stipulated in Section 33(1) is the "*expenses wholly and exclusively incurred ….. in the production of gross income from that source*." The deductibility of interest costs rests on the usage of the proceeds. So long as an insurance company is able to demonstrate that the funds received (from issuance of debt papers) was laid out in the production of its shareholder's fund income (be it through buying more investments or funding the life/general business), tax deduction on interest should be accorded.

To encourage more participation by insurance companies/takaful operators in the capital market, CTIM would like to propose that the relevant sections 60 and 60AA of ITA be amended to allow tax deduction on interest costs on approved debentures so that the costs of investment can be accounted and the return on investment is equitably assessed.

2. Promoting Initial Public Offerings (IPOs) and Listing in Bursa Malaysia

Generally companies will undergo extensive restructuring exercise and transfer assets and liabilities before application for listing in Bursa Malaysia to ensure operating efficiency and listing requirements.

Comments:

To promote IPOs and listings in Bursa Malaysia, the Institute is of the view that the authority should consider a blanket exemption be granted on stamp duty and Real Property Gains Tax to facilitate the exercise.

C. ISSUES RELATED TO CAPITAL MARKET PRODUCTS AND DEDUCTIBILITY OF EXPENSES

1. Discount/Premium Expense on Bonds Incurred by Non-financial Institutions

Currently, the tax treatment of discount/premium expense on bonds issued by non-financial institutions is specifically provided under Section 34C of the Income Tax Act, 1967 [ITA].

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The discount/premium on bonds is deductible by a non-financial institution, on an accrual basis as follows:-

- Firstly, against discount/premium income derived by the company; and
- then, in the event the company does not have any, or have insufficient discount/premium income, against business income, provided the bond proceeds are used wholly for business purposes.

The above treatment has led to the following which is very common among non-financial institutions:-

- discount/premium on bonds issued for mixed purposes i.e. to partly finance investment and business, would not be deductible as the condition that proceeds of the issue be utilized *" wholly….for the production of gross income from any source or sources consisting of that business. "* is not met; and
- discount/premium on bonds issued by investment holding companies and special purpose vehicles, would not be deductible as such entities do not have business income.

In addition, the above treatment compares unfavorably to that accorded to financial institutions. A financial institution is allowed to claim a tax deduction for the discount/premium on bonds on an accrual basis provided that the financial institution is able to prove that the expense is wholly and exclusively incurred in the production of its gross income.

The treatment of discount/premiums on bonds for non-financial institutions under Section 34C is not consistent with the original intention as announced in the 2006 Budget which is "*to accord equal tax treatment between financial and non-financial institutions as well as to encourage non-financial institutions to opt for the issuance of bonds as an alternate source of funding*."

Comments:

In view of the above intention and to ensure a robust bond market, the Institute is of the view that the treatment of discount/premium on bonds for non-financial institutions be aligned with that for financial institutions; i.e. the deduction for discount/premium on bonds is be allowed on an accrual basis provided the expense is wholly and exclusively incurred in the production of income.

2. Deduction for Expenditure on Treasury Shares

(a) Proper Legal Framework

While Sec 34D may be viewed as facilitating the use of Employee Share Option Schemes (ESOS) to reward employees and retain talent, it does increase the capital market activities. Therefore, it is important to ensure the legal framework is in place for the new Sec 34D to work.

Under the current legal framework, it is unclear whether treasury shares can be allotted to the employees since Section 67A of the Companies Act 1965 (Act 125) only allows a public company to purchase its own shares and the Board of Directors to either distribute the treasury shares as dividend or resell them in the open market of the Stock Exchange. In practice, the buyback of treasury shares is normally undertaken by a trust.

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Further, unlike Section 34D which is confined to treasury shares, it is a common practice for companies to issue new shares or purchase shares of other company within the group for the purpose of ESOS.

Comments:

If the government's intention is to prescribe a specific tax treatment for shares used to satisfy employer's obligations under an Employee Share Scheme (ESS), including employee share purchase plan, share award scheme, ESOS, etc. and to promote the use of ESS as a performance incentive, CTIM suggests that the provisions of Section 34D be extended to a trust or any other special purpose vehicle used to hold the shares for the purpose of ESS, and the actual cost incurred in issuance of new shares for the purpose of satisfying the obligations under a ESS, be allowed as a deduction so long as the provisions of Section 33(1) of the ITA are satisfied.

(b) Application of Bursa Malaysia Main Market Listing Requirements

Paragraph 18, Chapter 12 of the Main Market Listing Requirements issued by Bursa Malaysia Securities Berhad stipulates the range of resale prices.

Comments:

The Institute would like to seek clarification whether the sale of treasury shares to a company's own employees and employees of subsidiaries constitutes a resale of treasury shares, thereby violating the Rules of Listing Requirements.

(c) Restriction on application of the incentives

It appears that this deduction is **not available** to private companies and public companies not listed on Bursa Malaysia. It is also **not available** to companies having no business source of income, such as investment holding companies not listed on Bursa Malaysia and multinationals.

Comments:

The Institute would suggest that the Securities Commission look into the impact of such a restriction, with a view to increasing the size of the securities market and improving the means of attracting talents.

3. Asset Backed Securities

It was announced in the 2004 Budget that in order to stimulate the capital market and diversify sources of financing for economic development, the Government intended to ensure neutrality in tax treatment between asset-backed securities (ABS) and other securities approved by the Securities Commission.

The announcement did not address issues such as whether sales proceeds from hire-purchase receivables will be taxed over the period of the securitisation transaction; how the

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subsequent income of the special purpose vehicle (SPV) should be taxed in relation to the receivables; whether the SPV would be considered to be carrying on a business, whether SPV will be treated as an Investment Holding Company where Section 60F apply, etc. In addition, certain expenses incurred prior to the issuance of debt securities, and the initial rating fees incurred by a SPV are not allowed against its income.

The *Income Tax (Deduction for Expenditure on Issuance of Asset-Backed Securities) Rules 2005* [P.U.(A) No.321/2005] (the Rules) was gazetted on 2 August 2005 to specifically allow the costs of issuing ABS incurred by a company as a deduction against its business income. However, the Rules have expired since the year of assessment 2007.

On this matter, CTIM had submitted its comments on the draft **Income Tax (Asset-Backed Securitisation) Regulations 2003** to the IRB on 4 July 2007. CTIM had also been invited to a dialogue with the IRB and the Securities Commission on the draft **Income Tax (Asset-Backed Securitisation) Regulations 2007** on 21 February 2008. The proposed regulations have not been gazetted till this date.

Comments:

The objectives of introducing asset-backed securities are to stimulate the capital market and to diversify sources of financing for economic development. It is hope that the proposed Regulations will be issued as soon as possible to provide clarity and certainty to the potential originators of ABS.

There is a clear misalignment in promotion and implementation of ABS. While the Rules were intended to provide a thrust for the introduction of ABS, the tax treatment framework for ABS is not ready. Hence, the impact is lost. CTIM would like to suggest that the Rules be extended, in a manner similar to *Income Tax (Deduction on the Cost of Issuance of the Islamic Securities) Rules 2007* [P.U.(A) No176/2007].

In addition, the initial rating fees incurred by the SPV should be allowed as a deduction in the interest of maintaining tax neutrality and encouraging securitisation and enhancing the capital market

4. Deductibility Issues

a) Legal fees incurred in respect of obtaining capital

Paragraph 6 of the *Public Ruling No.6/2006 - Tax Treatment of Legal and Professional Expenses* stipulates that the following are examples of legal and professional expenses which will not qualify for deduction:

*"**6.1 Debt collection***

Legal and other expenses incurred by a person in the collection of non-trade debts and loans of a capital nature.

6.2 Renewal of loan

(a) Legal expenses incurred by a trading or commercial company.

(b) Legal expenses on renewal of a mortgage on premises.

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(c) Cost of raising additional capital whether by means of a loan or otherwise (this will also apply to a person carrying on a business of banking or money-lending)."

Comments:

CTIM is of the view that to facilitate participation in capital markets, all legal and professional fees, including tax fees, should be allowed as potential players would require professional advice on the various aspects of the transactions.

b) Staff Training Fund (a.k.a. Staff Pinching Fund)

Briefly, the Guidelines on Staff Training Fund (STF) issued by Bank Negara Malaysia (BNM) provide that whenever a banking institution recruits an employee from another banking institution who earned a minimum monthly gross salary of RM4,000 (excluding bonus) in his/her previous employment, the recruiting banking institution has to contribute a sum equivalent to 6 months of the employee's new monthly gross salary (excluding bonus) to the STF, if the releasing banking institution disapproves the recruitment. The IRB is currently disallows this amount for deduction.

Comments:

We propose that the above amount, which is currently not allowed as a tax deduction, be allowed as this is additional costs incurred in recruiting an experienced staff which is cost incurred in the production of income.

c) Tax Deduction on Contribution made to Capital Market Compensation Fund

Pursuant to Capital Markets and Services (Capital Market Compensation Fund) (Contribution) Regulations 2012 *[P.U. (A) 482/2012]* , the holder of a Capital Markets Services Licence for dealing in securities, dealing in derivatives or fund management (including Private Retirement Scheme provider) are required to make a contribution (initial upon being licensed and annually thereafter) to the Capital Market Compensation Fund ("Fund") administered by a statutory body named Capital Market Compensation Fund Corporation. Failure to make contributions to the Fund is a breach of SC's licensing condition.

Comments:

The Institute would like to seek a confirmation that tax deduction will be granted to licence holders on such contributions (initial and annual) made to the Fund. For the avoidance of doubt, the tax deduction for initial contribution should also include the transfer of deposits previously lodged with the SC to the Fund.

5. Leasing arrangements

Currently, there are no specific regulations pertaining to an Islamic lease situation.

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Comments:

We are of the view that there is a need for such regulations be drafted to provide certainty on the tax treatment. In addition, it is noted that the Income Tax Leasing Regulations 1986 (ITLR) that were drafted in 1986 may also need to be revisited.

D. OTHER ISSUES RELATED TO THE VEHICLES

1. Exemption of Interest Income of Unit Trust Funds

Currently, interest income earned by a unit trust from financial institutions licensed under Banking and Financial Institutions Act 1989 or the Islamic Banking Act 1983 is exempted from tax. We understand that certain development financial institutions ("DFI") that are under the purview of BNM, are licensed under the Development Financial Institutions Act. The DFIs in Malaysia are specialised financial institutions established by the Government with specific mandate to develop and promote key sectors that are considered to be of strategic importance to the overall socio-economic development objectives of the country. These strategic sectors include agriculture, small and medium enterprises (SMEs), infrastructure, maritime, export-oriented sector as well as capital-intensive and high-technology industries. The DFIs are also allowed to accept deposits.

Comments:

Given the intention to exempt unit trusts from tax on interest income earned from deposit placements, we would like to propose that such exemption be extended to interest income earned from DFI.

2. Real Estate Investment Trusts (REITs)

(a) Review of withholding tax ("WHT") for Malaysian REITs Unitholders

In Malaysia, the following WHT would be applicable to distributions made by REITs to their unit holders (where the tax transparency treatment applies):

- 10% final WHT for distributions to individuals and institutional investors (resident and non-resident);
- 25% final WHT for distributions to non-resident corporate investors;
- No WHT is imposed for distributions to resident corporate investors but resident corporate investors would be taxed at the prevailing income tax rate (i.e. generally, 25%).

In comparison, in Singapore, distributions made by REITs to their unit holders (where the tax transparency treatment applies) would be subject to the following WHT:

- No WHT is imposed for distributions to individuals (resident and non-resident) and the distributions are exempted from tax in the hands of the individuals;
- No WHT is applicable for distributions to resident companies, branches of foreign companies (with waiver of WHT from the Comptroller of Income Tax)

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and bodies of persons incorporated or registered in Singapore but these entities will be taxed at their prevailing income tax rates (i.e. generally, 17%);

- 10% final WHT for distributions to non-resident non-individuals;
- WHT at the prevailing corporate tax rate (i.e. 17%) for distributions to others (e.g. Singapore branches of a non-resident company without waiver of WHT).

Hong Kong, on the other hand has no withholding tax on REIT distributions.

Comments:

CTIM is of the view that WHT for distributions made by Malaysian REIT should be reviewed to level the playing field for the Malaysian-REITS and its counterparts in the region (e.g. Singapore and Hong Kong to nil rates).

Further, it may also be worthwhile to consider providing further incentives (e.g. nil withholding tax) for Islamic REITs, to maintain Malaysia's leading position at the forefront of global Islamic Finance.

(b) Claim for Industrial Building Allowance (IBA) by the REITs

Traditionally, REITs deriving rental income from an industrial building may be granted industrial building allowance (IBA) under Schedule 3 of the ITA 1967, deductible against adjusted business income from their rental source, provided the tenant uses the building as an industrial building. The IRB has now taken the approach that for certain trades, only the owner of the business are allowed to claim the IBA.

In line with the new approach, Paragraph 7.5 of the Public Ruling No. 9/2012 -- Taxation Of Real Estate Investment Trusts/ Property Trust Funds further provides that a REIT must be the hotel operator in order to claim the IBA for the hotel building. This does not make sense as a REIT's principal activity is in the rental of properties and to derive rental income as a business. Hotel business is normally separately run by the operator of the hotel. On the same rationale, where a REIT rent a building for use as a school or educational institution approved by the Minister of Education or Minister of Higher Education, the REIT will not be entitled to claim IBA as it is not the operator.

Comments:

CTIM suggests that there is a need to review the impact of the above approach taken by the IRB on the REIT industry.

3. Review of tax incentive for fund management company

Currently, the statutory income of a fund management company derived from a business of providing Islamic fund management services to local or foreign investors is exempt from tax. In addition, a foreign fund management company which provides fund management services to foreign investors is also taxed at the concessionary tax rate of 10%.

Notwithstanding this, as the definition of 'local investors' and 'foreign investors' have been narrowly defined in the relevant legislations to include individuals, companies and trust funds

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only, fund management companies which provide services to entities such as the Employees Provident Fund and Bank Negara Malaysia would not be eligible for the preferential tax treatments as these entities are neither individuals, companies nor trust funds.

Comments:

We are of the view that the definition of local / foreign investors in the relevant legislations should be reviewed to widen its scope.

In 2002, it was announced in the Budget speech that carried interest earned by a fund manager or manager is to be exempted from tax. Since then, there has been no Gazette Order or confirmation that carried interest will be tax exempted.

Comments:

This does not promote the fund management industry, especially the PE Fund management industry. As a result of the lack of clear legislation, fund managers prefer to set up fund management companies in Singapore, Labuan, the Cayman Islands, etc. There is a need to consider the tax exemption of carried interest earned in order to promote private equity funds.

Islamic fund management tax incentive is available until YA 2016. New players may give up any plans to set up funds in Malaysia since there are only 3 more years to enjoy the incentives.

Comments:

It suggested that this tax incentive be extended indefinitely. Alternatively, the exemption may be granted for 10 years to a company from date of starting business.

4. Tax neutrality for business trusts

Currently, stamp duty on all instruments executed by a TM on behalf of a BT in relation to the transfer of any business, asset or real property to a BT for the purpose of initial offering of the BT is exempted. Similarly, chargeable gains accruing on the disposal of any chargeable asset (including shares in a real property company) to a trustee-manager on behalf of a business trust is exempted from real property gains tax. However, there is no similar provision on transfer of business assets/liabilities such as stock-in-trade, debtors, creditors, etc. to a business trust from the income tax perspective.

Comments:

To provide more clarity and to promote the development of business trusts as a new investment vehicle, we are of the view that tax exemption should be introduced for the transfer of business assets/liabilities to a business trust to achieve tax neutrality.

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5. Treasury Management Centre (TMC)

The Income Tax (Exemption) (No.5) Order 2012 [P.U. (A) 240/2012] exempts a TMC from payment of income tax for five consecutive years of assessment in respect of the statutory income from the provision of qualifying services to its related companies, at least three of which must be located outside Malaysia.

However, Rule 4 of the above Order requires that any payment for qualifying services must be at arm's length and any interest charge are to be at market rate and the Director General of Inland Revenue is empowered to substitute the price for the qualifying services or disallow the excessive interest charged.

Comments:

It must be noted that the TMC are providing services to its related companies as a group and it may sometimes be difficult to convince the IRB to take into account special considerations applicable to the companies, or to disclose the full details of the arrangement to the IRB as justification for exemption.

6. Unit trust set up as a Restricted Investment Scheme (RIS)

Based on Section 4 of the SC guideline, the unit trust can be formed under a trust structure or a custodian arrangement. As a RIS is not formed under a trust structure, the RIS does not fall under Sections 61 and 63B of the ITA and accordingly, does not qualify for the tax exemptions under Schedule 6.

Comments:

The Institute would like to have clarification on whether the RIS is to be considered as a unit trust for tax purposes.

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