



Malaysia Vies to Maintain Leadership in Islamic Finance

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The days when Malaysia was striving to establish Islamic finance's value proposition and to carve out a niche for itself are long gone. The country has emerged as a leader of what today is a viable segment of an increasing number of capital markets around the world. Expanding from its early accomplishment, in 2002, of issuing the first global sovereign sukuk bond¹ and, in 2007, the largest-ever corporate sukuk, worth US\$4.8 billion, Malaysia continues to be one of the main countries issuing sukuks. It currently accounts for almost two-thirds of the US\$80 billion world sukuk market².

Other world-leading Islamic innovations from Malaysia include the first listed real estate investment trusts (REITs), the first rated residential mortgage-backed securities and the first exchange-traded fund. These accomplishments show Malaysia continuing to strive to raise the bar globally – both for product innovation and 'end-to-end' Shariah-compliant services.

With demand for Islamic financial products growing globally, Malaysia has set its sights on positioning itself as a leading international Islamic financial centre. To coordinate this, it established an initiative in 2006 to promote Malaysia as an international Islamic financial centre (the MIFC initiative). In order to achieve this, the government has used tax policy as a powerful incentive.

As early as 2001, Malaysia had the foresight to align the tax treatment of Islamic products with levies on conventional products. Consequently, Malaysia's current taxation regime is quite comfortable with Islamic financing methods. Since then, in line with its policies of converting at least 20% of the nation's assets to Islamic finance by 2010 (currently the level is roughly 12%), the government has introduced specific tax exemptions to encourage participation in Islamic instruments and to spur Islamic finance nationally. Some of its earliest tax exemptions included tax deductions granted on Islamic private debt securities, and tax exemptions on interest income earned by non-resident companies from specific Islamic securities or debentures.

To compete with Middle Eastern tax-free rivals, Malaysia's 2007 and 2008 budgets have introduced a string of incentives and exemptions. These are carefully crafted to boost international participation in specific Islamic sectors such as banking and takaful³, funds, REITs and capital markets.

Successful Tax Incentives

Some of the major tax incentives that have contributed to the success of the Malaysian Islamic financial industry are as follows:

Islamic banking and takaful business

Specific exemptions have been granted to the Islamic banking and takaful business. Among them are:

- Income tax exemption for international Islamic banks and Islamic banking units, as well as international takaful companies and takaful units until year of assessment (YA) 2016.
- Withholding tax exemption on any profits paid out by an Islamic bank to non-resident customers.
- Stamp duty exemption on instruments executed pertaining to Islamic banking and takaful activities in foreign currencies until 31 December 2016.
- Stamp duty exemption on instruments executed pertaining to Islamic securities issued in all types of currencies as approved by the Securities Commission (SC) under MIFC guidelines until 31 December 2016.

¹ A sukuk is a bond that is compliant with Shariah law.

² Source: Securities Commission, Malaysia.

³ The mutually cooperative form of insurance, where policyholders support one another in line with Islamic principles.



- Stamp duty exemption of 20% on instruments used in Islamic financial products approved by the Shariah Advisory Council of the central bank, or the SC, up to 31 December 2009.
- Tax deduction on expense incurred in establishing an Islamic stockbroking firm until 31 December 2009.
- Tax exemption until 31 December 2009 in respect of income derived from an approved branch, or investee company, of a company resident in Malaysia.

Currently, banks and insurance companies in Malaysia are taxed on a worldwide basis at a rate of 26% (to be reduced to 25% with effect from YA 2009). This means that licensed Malaysian banks and insurance companies will be subject to income tax on income received from overseas, including income from the foreign branches of Malaysian banks.

So, how does the MIFC incentive affect foreign and local banks, takaful and re-takaful companies? Upon approval, the MIFC incentives will effectively transform what would have been a 26% tax position on worldwide income to a completely tax-free position until YA 2016. This applies to all income received from Islamic transactions in foreign currencies from both non-residents as well as Malaysians (ie on worldwide Islamic foreign currency income). Such a wide breadth of tax-free income has attracted many a bank and takaful company to apply for this status. To date, eight takaful companies and 14 banks have obtained licences to operate within the ambit of MIFC. UNICORN International Islamic Bank Malaysia Bhd, the first international Islamic bank in Malaysia, which recently received its licence, has already secured several mandates from clients in Indonesia, the Middle East and Singapore to achieve its aggressive first-year revenue, which is estimated to be US\$14 million.

True to the aim of being an international platform, as well as promoting inbound Islamic investments, the local banks have been encouraged to expand their operations regionally and globally. To this end, any profits earned by the newly established branches overseas or remittances of new subsidiaries overseas will be tax-free until 31 December 2009.

With specific regard to the takaful business, the recent Budget seeks to level the tax playing field with conventional insurance business. As an illustration, consider a takaful company that is based on the Musyarakah principle. Unlike a conventional insurance business, which makes profits from premiums earned after expenses and claims, the takaful business earns its profits from fees for services rendered (ie services akin to fund management services) and shares any surplus profits made with its participants (ie the insured). Previous tax treatments sought to tax all profits of the takaful business without excluding the portion of the profits that were to be shared with the participants. However, the current tax treatment as announced in the 2008 Budget allows a deduction on profits distributed to the participant. This adjustment and others have brought the treatment of takaful and conventional businesses into line.

Islamic funds and fund management

Recognising the importance of the fund manager in promoting and growing the fund management industry and attracting funds from customers, exemptions have been provided on management fees until YA2016, for local and foreign companies managing approved Islamic funds for both local and foreign investors. This incentive may well result in a shift from conventional fund management to Islamic fund management.

Islamic capital markets

As mentioned, Malaysia is now among the most established Islamic capital markets worldwide. Some of the key incentives that have driven this are:

- Tax deduction on expenses incurred on the issuance of Islamic securities based on Ijarah (leasing), Istisna' (progressive sales), Mudharabah (profit-sharing), Musharakah (profit-and loss-sharing) and other Islamic products approved by the SC until 2010;
- Withholding tax exemption on interest received by non-resident companies in respect of debentures issued in ringgit or Islamic securities issued in any currency, other than convertible loan stock, as approved by the SC;



- Withholding tax exemption on interest received by non resident individuals in respect of Islamic securities, other than convertible loan stock, issued in any currency other than ringgit, as approved by SC.

These incentives attract foreigners to invest in Malaysia and ensure that Islamic securities remain competitive.

Other areas

Albeit the apparent success of the various incentives offered, further tax incentives have been provided as follows:

- Tax deduction on pre-commencement expenses of an Islamic stockbroking business, so long as the business starts operating within two years of SC approval;
- Tax relief not exceeding RM5,000 (US\$1,515) per annum to individuals on Islamic finance courses approved by Bank Negara Malaysia, the central bank, or the SC.

The notion of an Islamic stockbroking business is another Malaysian innovation. These incentives were devised in order to turn this concept into reality.

Additionally, in order to realise the MIFC's goals, the government acknowledged the immediate need to compete for a critical mass of experts in Islamic finance, especially since such experts are not likely to be taxed in the Middle East. Even countries such as Singapore are beginning to provide tax exemptions to such experts on a selective basis. Therefore, in addition to the tax relief for individuals on Islamic finance courses, the 2008 Budget removed tax on income received by verified non-resident experts in Islamic finance. This incentive is vital to the success of MIFC.

Defending A Position of Strength

Malaysia acknowledges that merely providing fiscal incentives without an enabling environment to attain these incentives will not prove sufficient to attract investors to achieve the MIFC's goals. Consequently, the MIFC Secretariat was recently established as a one-stop centre for all MIFC incentives, so simplifying bureaucratic procedures and streamlining the various Islamic tax incentives under a single authority.

With various Middle Eastern countries competing to become the world's leading Islamic centre, competition between different jurisdictions is tough. Malaysia is in a strong position, with a comprehensive Islamic regulatory system, as well as its continual development, refinement and innovation of Islamic concepts and financial instruments. As it defends its current position as one of the leading Islamic centres, tax incentives have an important role to play.

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