
Insights into the Taxation of the Financial Industry

Like the Twin Towers, the financial services industry is a juggernaut that no one can ignore. Unless we are living in Mars, our lives are impinged by these financial intermediaries one way or another, be they banks, insurance companies, stockbrokers, insurance adjusters or discount houses. It is a colossal industry - one that is not easy to fathom and especially that it is very much regulated by Bank Negara (Central Bank). Suffice to say, the financial services industry comprise a community of professionals whose passion is fuelled by money, risks and opportunities.

Unique Tax Treatments

Where there is money, the tax man cometh. For players in the financial industry, taxes are however not calculated in the usual way. For example, life insurance companies are taxed not on the premiums received but on income received from their investments. General insurance companies are taxed in the same manner but allowance is given for the insurer's "reserve fund for unexpired risks".

Banks are also required to account for taxes on their worldwide income whether earned in Malaysia or elsewhere. This is unlike other Malaysian companies which are taxed only on Malaysian income. This rare discriminating policy is nevertheless compensated by a credit for foreign tax incurred as well as a generous policy of allowance for doubtful debt write-offs against taxable income. Being in the money lending business, the interest income of banks and similar institutions is considered to be business income which is taxable even when it has yet to be received i.e. on the accruals basis.

On the other hand, non-financial institutions including individuals are generally taxed on their interest income only when received. Recipients can therefore avail themselves of deferring the income indefinitely although it may not be practical in most cases. Individuals are also able to enjoy tax exemptions for fixed deposits not exceeding RM100,000 per deposit. Should the deposit exceeded this threshold, the resulting withholding tax is only 5%. This is still an unwanted cost if one recognizes that non-residents are actually exempted from tax on their bank interest. It will not be difficult for a smart investor to find his way around this dichotomy.

Tax Benefits for Interest Expenses

To the tax professional, a tax deduction is a big deal akin to shaving a second off a Formula One driver's lap time. Whilst the bank derives income from interest, taxpayers incur interest expenses which should be claimed as a tax deduction wherever possible. This will reduce the taxable income and consequently, the tax liability. However, not all interest expenses are fully deductible for tax purposes.

Where interest is disallowed, the taxpayer's taxable income rises above his real income and the "gap" between the two gives rise to a higher effective tax rate compared to the standard corporate tax rate of 26%. To gain a full tax deduction, the interest must be incurred on a loan used to finance a business from which business income is derived. Without such a rule, a smart company will borrow money for investment into stocks and shares, obtain a deduction for the interest and not be taxable on the capital gains! If the loan is not utilized wholly for business, the infamous Section 33(2) of the Income Tax Act will come into effect. The deduction of a proportion of the interest using a formula based on the amount of non-business assets over the total loans of the taxpayer will not be allowed.

With the foray of the financial industry into Islamic financial products, one encounters new concepts of interest which take the form of profit sharing and sale and leaseback arrangements in Islamic financing. Happily, the law has kept pace and treated Islamic profit shares as interest according to Section 2(7) of the Income Tax Act. Hence, for tax purposes, Islamic financing profits are treated as normal interest even though the loans are packaged differently for lending purposes.

Section 2(8) of the Income Tax Act has also been enacted to treat a sale and leaseback transaction for the purpose of Islamic financing as no sale. Consequently, these types of Islamic financing will not give rise to profits or losses on disposals of assets for tax purposes. As an incentive for issuers of certain Islamic private debt securities (commercial papers, bonds, etc), issuance expenses incurred by these issuers are allowed for tax deduction.

Interest Expense under the Single Tier Tax System

With the introduction of the Single Tier Tax System (STTS) on 1 January 2008, interest expense has to be planned carefully. In the past, interest incurred on loans obtained to finance investments can be offset against the dividend income received. Furthermore, with the tax credit on the dividend, the taxpayer is able to get a tax refund from the government due effectively to the tax deduction of his interest expense against his dividend income. However, under the STTS, dividend income does not carry a tax credit anymore and any interest incurred in financing investments will not get a tax deduction. Taxpayers with such loans may now need to rethink their financing strategy.

Bonds and Securitization Arrangements

The financial industry has also evolved in recent years with the introduction of bonds and securitization arrangements. Bonds are merely medium to long term loans which are secured on certain assets. Although a bond by character, is a straightforward financial arrangement, its taxation has not kept up with changes in the industry. In particular, tax issues arise when bonds are not issued at normal interest rates but at "discounted" rates or at "zero rates". These discounted bonds or zero-coupon bonds carry low or zero interest rates but are in fact repaid at a higher amount on maturity.

The difference known as a bond discount is in the nature of an interest expense. One would expect the discount to be allowed for tax deduction on a straight line basis over the tenure of the bond as proposed in the 2006 Budget. Uncannily, when the law was promulgated, the deduction was allowed, subject to the condition that the company claiming it must be in the business of issuing bonds. By inference, normal companies which issued discounted or zero-coupon bonds as a means of financing cannot obtain the tax deduction progressively but only upon maturity. It certainly looks like the government authorities would have to go back to the drawing board to straighten out this issue.

Securitisation, which may be an intimidating term to the layman, is becoming common. It involves the sale of assets such as credit card receivables to a company which is set up specially to buy the assets. In this instance, the seller "securitises" the receivables by selling them to a company known as an SPV (special purpose vehicle) which will in turn finance the assets by issuing asset backed securities or bonds.

Under the securitisation arrangements, every party stands to gain. The party selling the assets would have profited from the sale and a lighter balance sheet with the removal of assets with low returns. The seller could then write more loans and gain more profits. The SPV would then made a profit on the "spread" derived from the income generated by the assets less the bond interest paid. The bondholders would too have a reasonable return on their bonds, usually at an interest rate far higher than for fixed deposits.

However, for tax purposes, there are no special rules to ensure neutrality for the taxation of these “securitisation” arrangements. There is no assurance that parties to the securitisation arrangement are taxed fairly and that the tax effects are neutral compared to non-securitisation arrangements.

Fortunately, securitisation guidelines have been prepared by the tax authorities and are awaiting final approval before being released to the public. Meanwhile, participants in this market have to make do with existing laws and thread carefully around ambiguities and potential landmines. Perhaps, this matter could be expedited for the good of the capital market.

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