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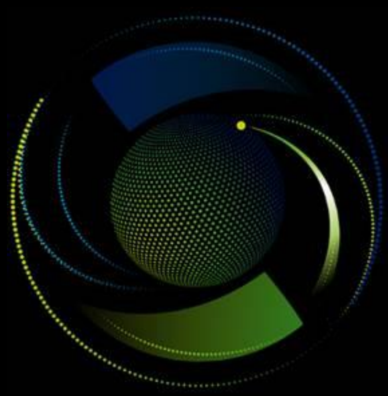

Tax Espresso - Special Alert

Guidelines on Tax Treatment of Hybrid Instrument

Introduction

The Inland Revenue Board Malaysia (IRBM) has recently published Guidelines on the Tax Treatment of Hybrid Instrument. These guidelines define the income tax treatment of hybrid instruments, including the factors generally used to determine if they are debt or equity instruments for income tax purposes.

This alert summarises the key features to determine if a conventional or Islamic hybrid instrument is classified as equity or debt instrument for tax purposes. We also look at the tax treatment of the profit distributions for both the holder and issuer of a hybrid instrument.

Classification of hybrid instrument

Issuers and holders of hybrid instruments (which exhibits both debt-like and equity-like features) are often concerned about whether the distributions are tax deductible/taxable, though this will depend on the tax classification. To determine if a hybrid instrument should be classified as an equity or debt instrument, we should look at the substance and real economic value of the instrument, and not just solely rely on its legal form. Once the classification of hybrid instrument is determined, the corresponding tax treatment would follow.

Examples of hybrid instruments include preference share, bond, perpetual loan, and profit participating loan note.

Factors to determine the classification of a hybrid instrument

The IRBM has laid out various factors in determining a hybrid instrument as either equity or debt instrument. The presence of any single factor is insufficient, and the combination of factors and surrounding circumstances should be considered in determining the classification of a hybrid instrument.

1. **Conventional hybrid instrument**

These factors and features are a non-exhaustive list and have been arranged according to the priority of determining the classification of a hybrid instrument.

Factors	Features	
	Equity	Debt
Source of repayment for the principal and payment of distributions or profits	Retained earnings or restrictive reserve	Not subjected to issuer's profit and liability to pay is accumulative
Priority of principal repayment in the event of liquidation or dissolution	Lower than creditor or debt holders Holder assumes responsibility for potential losses	Higher than equity holders Payment is mandatory and / or cumulative
Right of holder to enforce payment	Holder has no right to enforce payment	Holder has absolute authority to demand payment
Right to recover in the event of default	Holder has no right to recover	Holder has the right to recover normally under the step-up feature found in perpetual instruments
Maturity date of instrument	No fixed repayment date or step-up feature	Fixed repayment date and has step-up feature
Ability of issuer to obtain a loan and make payment on an arm's length transaction	The terms and conditions of the loan are unreasonable, and no independent creditor will provide similar loan with such terms. This usually	Issuer has the capability to secure a loan to fulfil payment obligations through arm's length transactions

	involves a transaction between either controlled companies or related companies	
Involvement in the management	Holder has voting rights If the holder has no voting rights, it could still be an equity instrument. It should be further evaluated based on other factors	Holder has no voting rights
Benefit to the holder	Holder may expect profits and a long-term capital appreciation of the investment	Holder may expect a return on investment, which is a steady stream of recurring income instead of capital appreciation

2. Islamic hybrid instrument

Sukuk is an Islamic financing instrument that is similar to a bond, but complies with Shariah principles. The classic features of Sukuk such as profit from ventures will be distributed according to the pre-agreed profit-sharing ratio, no guarantee on profit rate and impairment of capital or principal when the contract incur loss provide clear evidence that *Musyarakah* or *Mudharabah* contract is an equity instrument.

Developments in the Islamic financial system has resulted in new innovations in structuring *Musyarakah* or *Mudharabah* sukuk, where the expected profit rate is fixed and guaranteed, may have deferred features and return of capital or principal is assured. Instruments with such features are categorised as a debt instrument.

Various factors discussed in the table above for conventional hybrid instrument can be applied in determining if an Islamic hybrid instrument is equity or debt in nature, except for the source of repayment (first factor discussed in the table above).

For a conventional hybrid instrument, if the source of repayment of principal and payment of distributions or profits are dependent on retained earnings or restricted reserve, the instruments are equity in nature. However, in the case of Islamic instruments (whether general or hybrid), the existence of a reserve for the purpose of profit payment such as the Profit Equalization Reserve (PER) is intended to ensure that the profit from the sukuk program is not mixed with business profit.

Therefore, the first factor (source of repayment) is not applicable in the case of Islamic hybrid instrument as long as the payment of distributions or profits to the sukuk holder from the PER is from the current profit of the sukuk.

3. Tax treatment of equity instrument

If a hybrid instrument has been categorised as equity for income tax purpose, any payment arising from the instrument is treated as profit distributions. Dividends can be issued to shareholders, while other forms of distributions are reserved for non-shareholders.

	Tax treatment
Instrument holder	1. Dividends received from a company resident in Malaysia is tax-exempt under paragraph 12B, Schedule 6 of the Income Tax Act 1967 (ITA). 2. Foreign dividend income received in Malaysia from 1 January 2022 until 31 December 2026 may qualify for tax exemption under the Income Tax (Exemption) Order (No. 6) 2022 [P.U.(A) 235/2022] and Guidelines on Tax Treatment in Relation to Income Received from Abroad (amendment) issued on 29 December 2022. *[Income Tax (Exemption) Order (No. 6) 2022 (Amendment) order 2024 [P.U.(A) 157/2024] and Guidelines on Tax Treatment in Relation to Income Received from Abroad (Amendment) dated 20 June 2024 were recently issued.]* 3. Distributions on instrument issued by REIT are taxable depending on unit holders' activities. 4. In all other cases, financial instruments are assessable to tax in accordance with the relevant current tax treatment in Malaysia and provided not specifically exempt.
Instrument issuer	Any payment made by the issuer in relation to the instrument is not an allowable deduction under Section 33(1) of the ITA or other similar provision of any tax laws in Malaysia.

4. Tax treatment of debt instrument

If a hybrid instrument has been categorised as debt for income tax purposes, any payment arising from the instrument will be treated as interest. This includes profit from Islamic instrument with debt features in accordance with Section 2(7) of the ITA.

	Tax treatment
Instrument holder	Receipt of interest arising from the instrument is taxable in the hands of the instrument holder in accordance with the relevant current tax treatment in Malaysia unless tax exemption granted, includes but not limited to: 1. Non-resident companies for ringgit-denominated sukuk (other than convertible loan stock) approved by the Securities Commission Malaysia (paragraph 33A, Schedule 6 of the ITA). 2. Any person for non-ringgit sukuk originating in Malaysia (other than convertible loan stock) and approved by the Securities Commission Malaysia or Labuan Financial Services Authority (paragraph 33B, Schedule 6 of the ITA). 3. Any individual, unit trust and listed close-end fund in respect of debentures or sukuk, other than convertible loan stock approved by the Securities Commission Malaysia (paragraph 35, Schedule 6 of the ITA).
Instrument issuer	Any sum payable in relation to the instrument is allowed as deduction under: 1. Section 33(1) of the ITA and subject to restriction under Section 33(2) of ITA and other provisions under the ITA; or 2. Similar provisions as stated in paragraph 6.2.3(a) involving any tax laws in Malaysia.

The two tax treatments explained in the table above were discussed in Appendices A and B of the guidelines.

- Case study in Appendix A relates to a Perpetual Notes classified entirely as a debt instrument by the IRBM. Distribution may be taxed in the hands of instrument holder and distribution expense incurred by the issuer of the instrument is eligible for a deduction under Section 33(1) of ITA.
- Case study in Appendix B relates to a Perpetual Sukuk classified as an equity instrument by the IRBM, considering its two debt features versus five equity features. In this case, distribution arising from the equity instrument is profits distribution other than dividends and shall be taxed on the instrument holder in accordance with the relevant current tax treatment. Distribution expenses incurred by the issuer is not eligible for deduction under Section 33(1) of ITA.

Please refer to the [Guidelines on Tax Treatment of Hybrid Instrument] for full details.

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