



Taxavvy

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Guidelines on Tax Treatment of Hybrid Instrument



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Guidelines on Income Tax Treatment of Hybrid Instrument

The Inland Revenue Board (IRB) has issued the Guidelines on Tax Treatment of Hybrid Instrument dated 19 June 2024.

The Guideline is available on the IRB's website www.hasil.gov.my (Home > Legislation > Guidelines > Technical Guidelines)

In brief

The IRB has issued the guidelines to explain its tax treatment for issuers and holders of hybrid instruments, including Islamic instruments. The following non-exhaustive factors, listed in order of priority, are used to determine whether a hybrid instrument should be categorised as an equity or debt instrument for tax purposes:

1. The source from which the principal will be repaid and the distributions or profits will be paid, as well as the order in which they will be repaid in case of liquidation or dissolution.
2. Right to enforce payment of distributions or profits and principal by instrument holder
3. Right to recovery in the event of default
4. Maturity date of instrument
5. The ability of the issuer to obtain loan and makes payment on an arms' length transaction
6. Involvement in management
7. Benefit to the instrument holder

The tax treatment follows the categorisation of the instrument based on the above factors. Payments from equity-based instruments are treated as profit distributions, while payments from debt-based instruments are treated as interest.

In detail

The guidelines set out IRB's explanation and treatment on:

1. Key features of a hybrid instrument and factors in determining whether a hybrid instrument is an equity or a debt instrument for tax purposes.
2. Tax treatments of receipt of distribution or profit from hybrid instruments in the hands of the instrument holders as well as payment made by the issuers of hybrid instruments.

The equity or debt nature of a hybrid instrument must first be identified and determined before applying the tax treatment.

General features of equity and debt

The following are the general features set out by the IRB:

No.	Equity	Debt
1	Entitled to partake in share of distributions or profits of the entity	The right to receive distributions or profits is fixed
2	Entitled to residual assets of the company after repayment to debt holders upon liquidation	Entitled to reimbursement of the principal amount of debt during liquidation
3	No maturity date	With maturity date
4	Has voting rights	No voting rights
5	Payment of distributions or profits is at the discretion of the issuer's management	Instrument holder has the legal right to demand payment of distributions or profits



Factors to determine equity or debt classification of the instrument

The determination should be based on the substance and not solely on the legal form of the instrument.

The guidelines listed the following non-exhaustive factors, in order of priority to be considered in determining whether an instrument is a debt or an equity instrument:

1. The source from which the principal will be repaid and the distributions or profits will be paid, as well as the order in which they will be repaid in case of liquidation or dissolution.
2. Right to enforce payment of distributions or profits and principal by instrument holder
3. Right to recovery in the event of default
4. Maturity date of instrument
5. The ability of the issuer to obtain loan and makes payment on an arms' length transaction
6. Involvement in management
7. Benefit to the instrument holder

The combination of factors listed above as well as the facts and circumstances surrounding the instrument need to be taken into account in determining whether an instrument is a debt or an equity instrument.

Please refer to Table 1 in the following page for details on how the above factors are used in determining whether an instrument is a debt or an equity instrument.

The guidelines also included 2 examples in Appendix A and Appendix B which can be used as a guide in determining whether an instrument is a debt or an equity instrument.



Table 1: Summary of factors to determine equity or debt classification of the instrument

The salient points of each factor are as follows:

Factor	Equity	Debt
1. <i>Source</i> for principal repayment and payment of distributions or profits; and <i>order</i> of repayment in case of liquidation or dissolution	<ul style="list-style-type: none"> ● Source of repayment is dependent on retained earning or restricted reserve; or ● In the event of liquidation or dissolution, instrument holder: <ul style="list-style-type: none"> ○ is ranked after general creditor or a holder of subordinated debt; or ○ may suffer loss incurred by the issuer that could reduce the principal amount of the instrument. 	<ul style="list-style-type: none"> ● Repayment is not subjected to the instrument issuer's profits (regardless of financial well being) and liability to pay is accumulative; or ● In the event that payment of distributions or profits is mandatory and/or cumulative. <p>Existence of dividend stopper is not conclusive for the instrument to be regarded as a debt.</p>
2. Right to enforce payment of distributions or profits and principal by instrument holder	Instrument holder does not have any means to enforce payment.	Instrument holder usually has the absolute authority to demand payment. Usually a clause of 'Event of Default and Enforcement' exists.
3. In the event of default	Instrument holder does not have any right to recover the principal or the accumulated distributions or profits.	<p>Instrument holder has right to recover the principal or the accumulated distributions or profits.</p> <p>A step-up feature is an indication that the instrument is a debt.</p>
4. Instrument's maturity date	No fixed repayment date or step-up feature.	With a fixed repayment date or a step-up feature.
5. Issuer's ability to obtain loan and make payment at arm's length	Terms and conditions of the loan obtained are unreasonable and not at arm's length.	Loan is secured at arm's length by the issuer.

Table 1: Summary of Instrument Determination Factors (cont.)

Factor	Equity	Debt
6. Involvement in management	<p>Instrument holder has voting right at general meetings.</p> <p>The IRB states that this factor alone does not automatically conclude the character of the instrument. A holistic evaluation of all the other factors are to be taken into account.</p>	<p>Instrument holder does not have voting right in general meetings.</p> <p>Certain instruments have the potential to be equity even without the right of involvement in management.</p>
7. Benefit to the instrument holder	<p>Instrument holder invests in the instrument with the expectation of participation in profits and long-term capital appreciation of the value of the investment.</p>	<p>Instrument holder invests with the expectation of a return on the sum invested (a steady stream of recurring income) regardless of the profitability of the entity. The holder does not expect capital appreciation of their investment.</p>

Tax treatment for holder and issuer of instrument

1. If a hybrid instrument is categorised as *equity* for tax purpose, payments arising from the instrument are treated as *profit distribution*:

Treatment for issuer

Not tax deductible under section 33(1) of the Income Tax Act 1967 (ITA 1967) or other similar provision.

Treatment for instrument holder

For shareholders, the payment is treated as dividend. The general tax treatment relating to dividend are:

- Dividend received from a Malaysian resident company: Tax exempt (single-tier dividend)
- Foreign-sourced dividend: Amounts received into Malaysia by residents are subject to tax. However, subject to conditions, amounts received from 1 January 2022 to 31 December 2026 may qualify for exemption (refer to [TaXavvy Issue 22-2024](#)).

For instruments issued by a real estate investment trust, the taxability will depend on the profile of the unit holders.

2. If a hybrid instrument is categorised as *debt* for tax purpose, payments arising from the instrument are treated as *interest*:

Treatment for issuer

Payments are eligible for tax deduction as interest expense, subject to meeting the prevailing deduction rules related to interest expense under the ITA 1967, including interest restriction rules.

Treatment for instrument holder

Payments are treated as interest income and are taxable for the instrument holder unless specifically exempted from tax.



Islamic hybrid instruments

Equity instrument

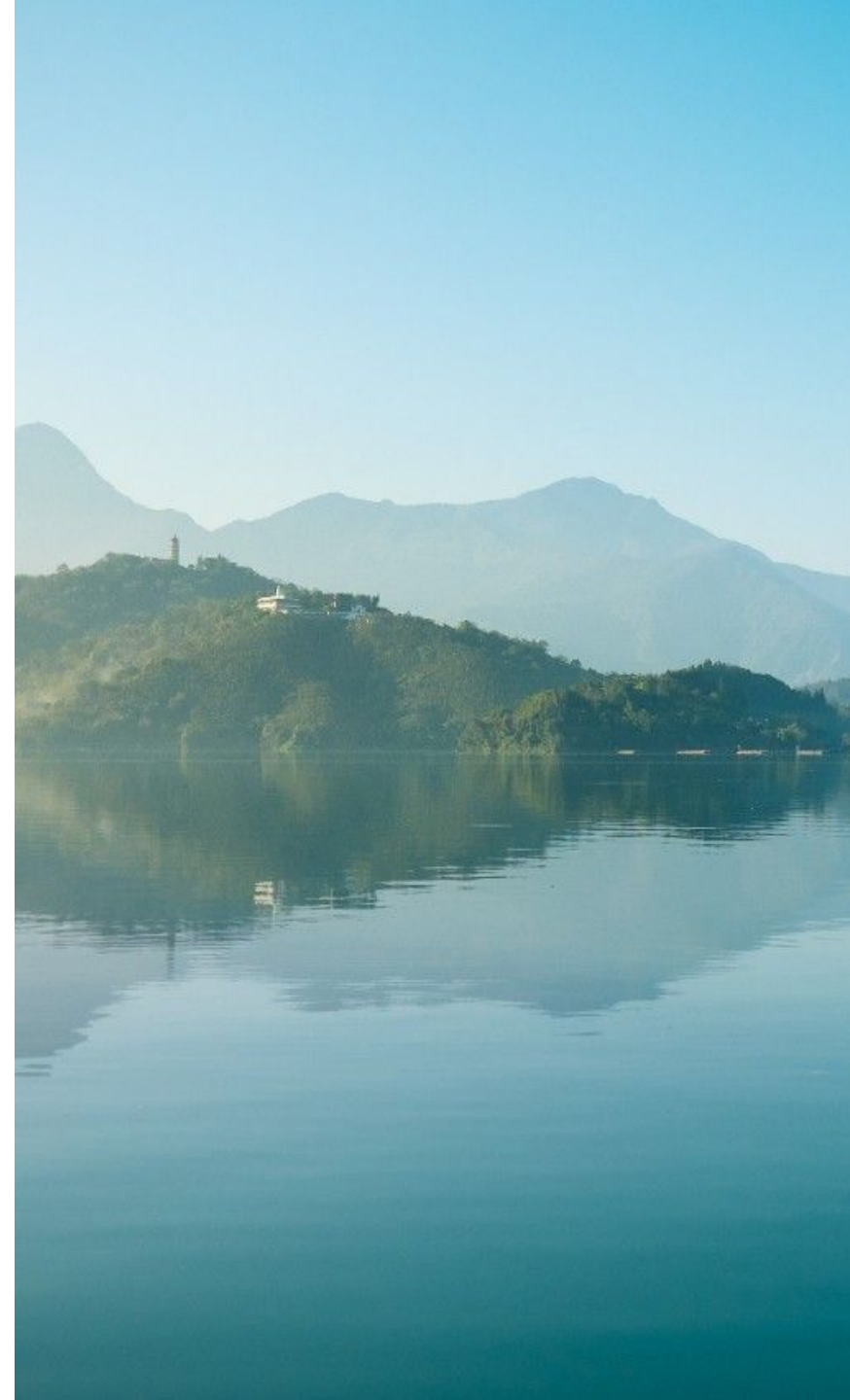
The IRB explains that the classic features of Sukuk such as profit from ventures will be distributed according to the pre-agreed profit sharing ratio, no guarantee on profit rate and impairment of capital/principal when the contract incur loss provide clear evidence that Musyarakah or Mudharabah contract is an equity instrument.

The IRB states that payments from a Profit Equalisation Reserve (PER) is not applicable for the determination of equity character of Islamic Hybrid instruments as long as the payment is from the current profit of the Sukuk.

Debt instrument

Musyarakah or Mudharabah Sukuk where the expected profit rate is fixed and guaranteed, may have deferred features and return of capital / principal is assured. The IRB categorises such instrument as a debt instrument.

The IRB states that other factors which are set out in Table 1 (refer pages 5 and 6) can be applied to determine the equity or debt nature of the Islamic instrument for tax purposes.



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