



GUIDELINES ON TAX TREATMENT OF HYBRID INSTRUMENT

1. INTRODUCTION

- 1.1 In general, the tax treatment of distributions or profits from a financial instrument is based on whether the holding of the instrument is an equity or debt in nature.
- 1.2 The following are general features of the holding of equity and debt instruments:

General Features	
Equity Holding	Debt Holding
Entitled to partake in share of distributions or profits of the entity, namely dividend, distribution from Real Estate Investment Trust (REIT) and return, interest or premium arising from profit.	The right on distributions or profits is fixed.
Entitled to residual assets of the company after the repayment to debt holders upon liquidation.	Entitled to reimbursement of the principal amount of debt during liquidation.
No maturity date.	Has maturity date.
The right to vote.	No right to vote.
Management of the entity has discretion to make payment of distributions or profits.	Instrument holder has a legal right to demand payment of distributions or profits.

- 1.3 The application of current tax treatment would have to consider specific features of the hybrid financial instrument (hereinafter referred to as “hybrid instrument”) which carries both, equity and debt features.

- 1.4 In this regard, the test to determine whether the features of the hybrid instrument is equity or debt must be carried out first before the tax treatment is applied.

2. OBJECTIVE

- 2.1 These guidelines are intended to provide an explanation on:
 - 2.1.1 Key features of a hybrid instrument and factors that are taken into consideration in determining whether a hybrid instrument is classified as equity or debt for tax purposes.
 - 2.1.2 Tax treatment related to the distribution or profit on a hybrid instrument for both the holder and issuer of the instrument

3. INTERPRETATION

- 3.1 For the purpose of this guidelines:
 - 3.1.1 "hybrid instrument" refers to a financial instrument that exhibits both equity and debt features. Examples include preference share, bond, perpetual loan and profit participating loan note.
 - 3.1.2 "instrument holder" refers to the person who subscribed a hybrid instrument.
 - 3.1.3 "instrument issuer" refers to the person responsible for authorizing a hybrid instrument encompasses a broad range of persons but is not limited to:
 - a) Company incorporated in Malaysia including Labuan entity;
or
 - b) Trustee of a REIT.

4. FEATURES OF HYBRID INSTRUMENT AND FACTORS THAT DETERMINE THE NATURE OF HYBRID INSTRUMENT

- 4.1. Determining whether a hybrid instrument is equity or debt should be based on the substance of the instrument and not solely on the legal form of the instrument. From a tax perspective, it is vital to determine the real economic value of an instrument by examining the legal rights and obligations created by the instrument, the facts and circumstances surrounding the instrument (substance) and a combination of factors listed in paragraph 4.2 before considering whether it is regarded as equity or debt.

4.2. The criteria for determining the classification of a hybrid instrument as either equity or debt for tax purposes encompass various factors which include, but are not restricted to the following factors:

4.2.1. 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.

The instrument is an equity if:

- a) Source of repayment of principal and payment of distributions or profits are dependent on retained earnings or restricted reserves; or
- b) In the event of liquidation or dissolution:
 - i) The priority of principal's repayment for an instrument holder is lower compared to that of a general creditor or a holder of subordinated debt; or
 - ii) Instrument holder is expected to assume responsibility for any potential losses incurred by the issuer of the instrument. This could involve reducing the principal amount of the instrument in order to compensate for the losses, whether they occur in the present or the future or conversion to ordinary shares by the instrument issuer.

The instrument is a debt if:

- a) Repayment of principal and payment of distributions or profits are not subjected to the instrument issuer's profits (regardless of the financial well being) and liability to pay is accumulative; or
- b) In the event that payment of distributions or profits is mandatory and / or cumulative.

The existence of dividend stopper or restrictive clause in terms and conditions of the instrument is not sufficient to regard the instrument as debt.

Dividend stopper or restrictive clause prohibits the issuer from declaring distributions or profits to other categories of investors if the distribution on that instrument is not paid.

4.2.2. Right to enforce payment of distributions or profits and repayment of principal by instrument holder

Usually a clause of 'Event of Default and Enforcement' exists in the terms and conditions of a debt instrument. The holder of a debt instrument has the absolute authority to demand payment of distributions or profits, as well as the repayment of the principal amount, on a fixed date and at a fixed amount.

On the other hand, if the instrument does not provide the instrument holder with any means to enforce payment of distributions or profits and repayment of principal, the instrument is an equity instrument.

4.2.3. In the event of default

In the event of default and the instrument holder has no right or conditional right to recover the principal or the accumulated distributions or profits, then the instrument is an equity.

The existence of a step-up feature indicates that the party issuing the financial instrument is obligated to reimburse the principal amount. The inclusion of a step-up feature, which is commonly found in perpetual instruments, can potentially incur additional costs for the issuer to maintain the instrument and may prompt early redemption. The feature is a mechanism to control perpetual instrument from continuing without certainty of repayment. This is an indication that the instrument is a debt.

The step-up refers to a feature which has an increase in the rate of distribution at a specific point in time or interval if the instrument have not been redeemed.

4.2.4. Maturity date of instrument

The presence of fixed repayment date, the existence of step-up feature or option, it indicates the debt nature of an instrument.

On the contrary, if there is no fixed repayment date or step-up feature or option, this indicates that the instrument is an equity instrument.

4.2.5. The ability of the issuer to obtain loan and makes payment on an arms' length transaction

An instrument is considered as a debt instrument when the issuer has the capability to secure a loan and fulfills the payment obligations through an arm's length transaction.

An instrument is considered as an equity instrument when its terms and conditions are unreasonable and no independent creditor will provide a similar loan with such terms. This usually involves transaction between controlled companies or related companies.

The findings from the leverage ratio analysis and examination of the issuer's financial statements (including cash flow statements) can demonstrate its ability to cover debt obligations and guarantee repayments of debt.

4.2.6. Involvement in the management

An instrument holder is given voting right at the general meeting, this denotes that the instrument is an equity.

However, if an instrument does not confer voting right, this does not automatically disqualify it from being an equity. In the case of controlled or related party financing, although there is no right of involvement in management, the instrument has the potential to be equity. The instrument should be further evaluated based on other factors in determining equity-debt feature.

4.2.7. Benefit to the instrument holder

Equity holder typically invests in the instrument with the expectation of participation in profits and long-term capital appreciation of the value of the investment.

Debt holder typically invests with the expectation of a return on the sum invested regardless of the profitability of the entity. A debt holder does not expect capital appreciation of their investment and seek to secure a steady stream of recurring income over the life of the investment.

- 4.3. Factors in paragraph 4.2 have been arranged according to **orders of priority** in determining the nature of instrument whether equity or debt.

- 4.4. The presence of any single factor is insufficient to determine the hybrid instrument as either equity or debt. The combination of factors and consideration of facts and circumstances need to be taken into account.
- 4.5. The accounting treatment of a hybrid instrument should be determined in accordance with prevailing accounting standards adopted in Malaysia. Where the substance of the instrument, as viewed from an accounting standpoint, contradicts the tax principles, it is important to take into account the factors listed in paragraphs 4.2. These factors will help determine whether the instrument should be classified as equity or debt.
- 4.6. Case study in Appendix A and Appendix B can be referred in determining whether an instrument is equity or debt. Both case studies are non-exhaustive and for reference only.

5. ISLAMIC HYBRID INSTRUMENTS

- 5.1. Sukuk is an Islamic financing instrument that is similar to bond but complies with Shariah principles. Depending on the underlying Shariah contracts, sukuk can be structured to be either equity or debt.
- 5.2. Sukuk that is structured based on the principles of Musyarakah or Mudharabah are equity in nature. 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.
- 5.3. Developments in the Islamic financial system have 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/principal is assured. Instruments with such features are categorized as a debt instrument.
- 5.4. Musyarakah or Mudharabah sukuk are considered as an Islamic hybrid instrument due to the structural innovation as stated in paragraph 5.3.
- 5.5. As stated in paragraph 4.2.1 for conventional hybrid instrument, if the source of repayment of principal and payment of distributions or profits are dependent on retained earning or restricted reserve, the instruments are equity in nature.
- 5.6. 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.

- 5.7. Therefore, the elements in paragraph 4.2.1 are 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.
- 5.8. Although the modus operandi of Islamic hybrid instrument for payment of distributions or profits are different from conventional hybrid instrument as described in 5.6 and 5.7, other factors discussed in paragraph 4 can be applied to determine whether the Islamic hybrid instrument is equity or debt in nature.

6. TAX TREATMENT

6.1. Tax treatment of equity instrument

6.1.1. 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.

6.1.2. Instrument holder:

- a) Dividends received from a company resident in Malaysia is tax-exempt under paragraph 12B, Schedule 6 of the Income Tax Act 1967 (ITA).
- b) Foreign dividend income received in Malaysia from 1 January 2022 until 31 December 2026 may qualify for tax exemption under 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.
- c) Distributions on instrument issued by REIT are taxable depending on unit holders' activities.
- d) 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.

6.1.3. Instrument issuer:

Any payment made by the issuer in relation to the instrument is not an allowable deduction under subsection 33(1) of ITA or other similar provision of any tax laws in Malaysia.

6.2. Tax treatment of debt instrument

6.2.1. If a hybrid instrument has been categorised as debt for income tax purposes, any payment arising from the instrument is treated as interest. This includes profit from Islamic instrument with debt feature in accordance to subsection 2(7) of ITA.

6.2.2. 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 granted tax exemption, includes but not limited:

- a) non-resident companies for ringgit denominated sukuk (other than convertible loan stock) approved by the Securities Commission Malaysia (paragraph 33A, Schedule 6 of ITA).
- b) 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 ITA).
- c) 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 ITA).

6.2.3. Instrument issuer:

Any sum payable in relation to the instrument is allowed as deduction under:

- a) Subsection 33(1) of ITA and subject to restriction under subsection 33(2) of ITA and other provisions under the ITA; or
- b) similar provisions as stated in paragraph 6.2.3(a) involving any tax laws in Malaysia.

7. DISCLAIMER

The examples in the Guidelines are for illustration purposes only and are not exhaustive.

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Case Study of Debt Instrument

Suria Indah Berhad (SIB) is a company incorporated under Companies Act 2016 which carry out real estate construction activity in Penang. SIB has issued Perpetual Notes under the Private Debt Securities Program which has been approved by the Securities Commission Malaysia.

The following is an analysis of this hybrid instrument in determining the nature of instrument for income tax purpose:

No.	Factors	Features	Analysis
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.	Principal Terms and Conditions of Perpetual Notes states that: - the payment of distributions or profits does not depend on retained earning or restricted reserved. - the obligation to pay is accumulative.	A debt feature.
2.	Right to enforce payment of distributions or profits and principal by instrument holder	Event of Default and Enforcement clause stated that Perpetual Notes holder conferred the right to claim the debt when default occurs.	A debt feature.
3.	In the event of default	Extract from Principal Terms and Conditions of Perpetual Notes states that: <u>Enforcement Event</u> (i) Issuer of Perpetual Notes fails: (a) to pay Distribution including Distribution arrears; or (b) to balance related to nominal value including Balance of Distribution arrears to the Perpetual Notes and the failure persists for a period of five (5) working days; or (ii) The Court decides to wind up or dissolve the issuer of the Perpetual Notes. <u>Enforcement Remedy</u>	A debt feature.

APPENDIX A

		<p>With the occurrence of item (i) above, the Trustee may exercise the issuer's responsibility for failure in payment by taking winding up action or liquidation claim.</p> <p>With the occurrence of item (ii) above, the Trustee may declare at its discretion by special resolution, all remaining Perpetual Notes including arrears of Unpaid Distribution, payable immediately by the issuer.</p>	
4.	Maturity date of instrument	No maturity date but Perpetual Notes have step-up distribution rate.	The presence of step-up distribution rate, renders the Perpetual Notes as a debt feature.
5.	The ability of the issuer to obtain loan and makes payment on an arms' length transaction	<p>Existing Perpetual Notes holder consist of unrelated listed companies.</p> <p>The current distribution rate of the Perpetual Note is equivalent to the market value.</p>	A debt feature.
6.	Involvement in management	<p>None.</p> <p>Perpetual Notes holder consist of unrelated listed companies.</p>	A debt feature.
7.	Benefit to the instrument holder	The Perpetual Note holder has no interests in the company and have no voting rights.	A debt feature.

Based on the above analysis, it indicates that the Perpetual Notes is treated as debt. Distribution arising from this instrument may be taxed in the hands of instrument holder. Distribution expense incurred by the issuer of the instrument is a deduction eligible under subsection 33(1) of ITA.

Case Study of Equity Instrument

Alba Haba Sdn Bhd (AHSB) is a subsidiary company incorporated under Companies Act 2016. AHSB is an investment holding company. The company issued Perpetual Sukuk under the Private Debt Securities Program which has been approved by the Securities Commission Malaysia.

The following is an analysis of this hybrid instrument in determining the nature of instrument for income tax purpose:

No.	Factors	Features	Analysis
1.	Source 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.	Principal Terms and Conditions of Perpetual Sukuk states that: - the payment of distributions or profits does not depend on retained earning or restricted reserved. - the obligation to pay is accumulative.	A debt feature.
2.	Right to enforce payment of distributions or profits and principal by instrument holder	There is no Event of Default Clause.	An equity feature.
3.	In the event of default	There is no Event of Default Clause.	An equity feature.
4.	Maturity date of instrument	No maturity date.	An equity feature.
5.	The ability of the issuer to obtain loan and makes payment on an arms' length transaction	Holder of Perpetual Sukuk consist of related companies. The current distribution rate of Perpetual Sukuk is at 10.5% which is higher than average distribution rate of financial institutions (not at arms' length).	An equity feature.
6.	Involvement in management	None.	A debt feature.
7.	Benefit to the instrument holder	Holders of Perpetual Sukuk have no voting rights and no interests in the company. However, holders are related and have direct and indirect shareholding in the issuing company.	An equity feature.

Based on the above analysis, it indicates that the Perpetual Sukuk is treated as equity. Distribution arising from this instrument is profits distribution other than dividends and shall be taxed in accordance with the relevant current tax treatment. Distribution expenses incurred by Perpetual Sukuk issuer is not an eligible deduction under subsection 33(1) of ITA.