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Growth of REITs in Malaysia—A Tax Perspective

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Since 2005,18 real estate investment trusts ("REITs"), including several Islamic REITs, have been listed on the Malaysian stock exchange (as at December 31, 2016). What has spurred the growth of REITs in Malaysia? Will this trend continue following the 2017 ruling and legislative amendment that an approved REIT not listed would not qualify for the tax exemption even if the 90 percent threshold is met and would be taxed at the corporate tax rate?

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The Government of Malaysia first announced tax incentives for REITs in the Budget 2005 with the intent of promoting the growth of REITs in Malaysia as a vehicle for real estate investments. Prior to the Budget 2005, property trust funds were largely taxed in the same way as unit trusts. To help spur the growth of REITs, from the outset, exemptions were granted to exempt transfers of real property to a REIT approved by the Securities Commission ("approved REITs") from real property gains tax (which is chargeable on capital gains arising on the disposal of real property, amongst others) and stamp duty.

Other tax incentives were subsequently granted in stages, one of which was the grant of a full tax exemption at the REIT level on the income distributed to its unit-holders ("tax exemption"). In this regard, the Inland Revenue Board's ("IRB's") Guidelines on Real Estate Investment Trusts or Property Trust Funds issued on June 29, 2005 ("REIT Guidelines") stated that the government's objective in granting attractive tax incentives was to ensure that REITs would have more income available for distribution to unit-holders, give relatively high yields and to ensure that investing in REITs would be more attractive than investing in unit trusts, which invest mainly in equities.

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Parliament then legislated that with effect from the year of assessment ("YA") 2005, approved REITs (whether or not listed on Bursa Malaysia Securities Berhad ("Bursa"), the Malaysian stock exchange) would qualify for the tax exemption i.e. income would be fully tax-exempt at the REIT level and only the unit-holders would be taxed on their share of the distributions from the REIT.

In line with a "tax flow through" treatment to pass on the profits to unit-holders, a final withholding tax is imposed on the distributions received out of the REITs' tax-exempt income. The withholding tax rates have been reduced since 2005 and are currently at 10 percent for non-corporate investors (resident and nonresident) and foreign institutional investors (including pension funds and collective investment schemes). For unit-holders which are nonresident companies, the prevailing corporate tax rate applies.

Any undistributed income of an approved REIT would be taxed at the prevailing corporate tax rate at the REIT level and no further tax is imposed upon the distributions received by the unit-holders. The tax paid on its profits by the REIT would be attributable to its unit-holders and the tax is then set off against the unit-holder's own income tax liabilities.

With effect from YA 2007, a new condition was imposed before the tax exemption can be enjoyed, namely that a REIT must distribute at least 90 percent of its total income to unit-holders in the basis period for the same YA ("90 percent threshold"). If the 90 percent threshold is not met, then the entire amount of the REIT's chargeable income would be subject to tax at the prevailing corporate tax rate. REITs were thus incentivized to increase the distributions to unit-holders up to the 90 percent threshold in order to avail itself of the tax exemption.

However, with effect from YA 2017, section 61A of the Income Tax Act 1967 ("ITA") was amended and the tax exemption would only apply to approved REITs which are listed on Bursa ("2017 amendment").

"Special Deductions" for Pre-Commencement of Business Expenditure

Apart from that, the Income Tax (Deduction of Establishment Expenditure of Real Estate Investment Trust or Property Trust Fund) Rules 2006 [P.U.(A) 135/2006] ("rules") also permitted tax deductions for certain expenses incurred prior to the commencement of business, which would otherwise not be tax-deductible. Under the rules, legal, valuation and consultancy fees incurred for the purpose of establishing a REIT prior to obtaining the Securities Commission's approval of the REIT, are deductible.

"Special Treatment" of Rental Income as Business Income

The rental income received by a REIT from letting its real property is to be treated as business income pursuant to the "special treatment" provided under the ITA. However, due to the numerous restrictions imposed, the characterization as business income may not be an accurate depiction as the expenses incurred are deductible up to the amount of the REIT's gross income from the rental source in that YA only. Any excess expenditure is not deductible, cannot be carried forward to be set-off in subsequent YAs or deducted against other sources of income of the REIT for that YA. Similarly, the amount of capital allowance is restricted to the adjusted income arising from the rental source of that YA. Any unutilized capital allowance would be lost as they can neither be carried forward to be set-off in subsequent YAs nor set-off against other sources of income of the REIT for that YA.

Evolution of Public Rulings on REITs

Several public rulings have been issued by the Director General of Inland Revenue ("DGIR"), stating the DGIR's and IRB's (collectively "Revenue's") tax treatment of REITs. With effect from YA 2007, public rulings are binding upon the Revenue. However, as they merely set out the Revenue's views, taxpayers are not bound by interpretations which are inconsistent with the intent and language of Malaysian tax laws.

On September 8, 2017, a revised Public Ruling No. 5/2017 – Taxation of Real Estate Investment Trust or Property Trust Fund was issued by the DGIR ("2017 Ruling"), superseding an earlier version of the same issued on June 19, 2015. The 2017 Ruling largely confirms the Revenue's previous position on the tax treatment for REITs save for certain changes, some of which are briefly explained below.

According to the 2017 Ruling, in the light of the 2017 amendment, an approved REIT which is not listed on Bursa would not qualify for the tax exemption even if the 90 percent threshold is met and would be taxed at the prevailing corporate tax rate (currently 24 percent). This would mean that unit-holders may also be taxed at higher rates now that the 10 percent withholding tax (which is a final tax) is no longer applicable for unit-holders of unlisted REITs.

It is also pertinent to note that in an example given by the Revenue vide their Public Ruling No. 2/2015 (issued on June 19, 2015) and Public Ruling No. 9/2012 (issued on November 26, 2012) ("2012 Ruling") on the Taxation of Real Estate Investment Trust or Property Trust Fund, the Revenue indicated that a REIT which owns but does not operate a hotel, would not be eligible to claim industrial building allowance ("IBA") on the capital expenditure incurred to purchase that hotel on the basis that the owner of the hotel is not its operator. However, that example has been omitted in the 2017 Ruling and raises the question as to whether Revenue have now altered their position to allow IBAs to be claimed by taxpayers who own, but do not operate, hotels themselves.

The 2017 Ruling also confirms the Revenue's conservative approach regarding the deductibility of expenses as they seek to disallow legal, valuation and consultancy fees incurred for the purpose of establishing a REIT prior to obtaining the Securities Commission's approval of the REIT, which are in excess of the REIT's gross income for that YA, although no such restriction is expressly provided for in the rules themselves or in the Revenue's own 2012 Ruling. This is clearly a more restrictive approach than the language of the rules, which contain no such express limitation.

Trend in Downsizing Tax Incentives as REITs Scale Up?

Historically, the same tax incentives have been made available to approved REITs both listed and unlisted, on an equal footing. For instance, according to the 2017 Ruling, both listed and unlisted approved REITs are still eligible for the "special treatment" of rental income as business income. Hence, it is unclear as to why the tax exemption is now restricted to approved REITs which are listed on Bursa, whilst other tax incentives remain largely intact. Such a measure is unlikely to push private unlisted REITs towards listing and may only contribute to the capping of distribution pay-outs to unit-holders in order to foot the tax bill.

This is clearly a departure from the initial objectives stated in the Revenue's own REIT Guidelines and may well push businesses towards other more viable structures to manage and invest in real property. It is also imperative for the authorities to consider as to whether or not they are sending a message that this is part of a wider trend to whittle down existing tax incentives and increase and diversify the country's tax base, at the expense of businesses and investors.

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