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# An analysis of tax incentives for islamic home financing in Malaysia

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**Abstract**

Obtaining an affordable home financing facility is among the critical issues that needs to be highlighted in house ownership and Islamic home financing is one of the options available in Malaysian housing market. In Malaysian context, Islamic home financing has been widely discussed from the perspectives of legal, cost, product structure but not much has been emphasized on the tax policies especially the tax incentives. This paper examines the tax incentives offered by the Malaysian government for the period from 2019 to 2023 on Islamic home financing. These periods were analysed to understand the most recent policy by the government to promote Islamic home financing as well as the Islamic finance industry in Malaysia. The study uses descriptive content analysis in examining relevant tax documents to examine the tax incentives for Islamic home financing in Malaysia. The findings concluded that Islamic home financing in Malaysia is not given the appropriate tax incentives to encourage bank customers to obtain Islamic home financing. Furthermore, the type of tax incentives given to Islamic home financing for the period from 2019 to 2023 are similar and focused more on the Stamp duty and Real Property Gains Tax. To fulfil the aspiration as the preferred Islamic financial hub, more attractive tax incentives should be offered by the government to promote Islamic home financing which will benefit the Islamic finance industry as well. Despite the importance of Islamic home financing in the society, very few studies have attempted to highlight this issue as compared to other tax incentives in the Malaysian tax system which suggests an opportunity for researchers to explore this area.

Keywords: Tax incentives, Islamic home financing, Islamic finance, Content analysis.

## INTRODUCTION

Islamic finance is described as performing finance activities according to the Shariah law. Basically, there are 5 key elements that required to be strictly followed to comply with the Shariah. There are believe in divine guidance, prohibition of interest, prohibition of haram investment, encouraging risk sharing and financing is performed based on real assets (Malaysian Institute of Accountants, 2012). In complying with the Shariah, every financial activity must not involve the elements *of Riba* (interest), *Maysir* (gambling) and *Gharar* (uncertainty). Following the global financial crisis, there has been increased interest in Islamic finance, owing to concerns about the integrity of mainstream financial assets and the strict rules that apply to Islamic finance (Ahmad, 2020).

Since its establishment years ago, the market for Islamic finance continues to enjoy promising developments not only in Asia and Middle East but also in European countries despite global economic financial crises. For example, in the 2023 Islamic Financial Services Industry Stability Report, globally the value of Islamic Financial Services Industry has increased to an estimated of USD 3.25 trillion in 2022 as compared to USD 3.06 trillion in 2021. Meanwhile Southeast Asia was reported to contribute 23.3 percent of the total global market share for Islamic finance which came second after Gulf Cooperation Council (GCC).

The Islamic finance industry in Malaysia has started with the establishment of Lembaga Tabung Haji, a body which manages the *umrah* and haj for Muslims in Malaysia and since then, Islamic finance industry in Malaysia has seen rapid growth. For instance, according to the Islamic Financial Services Industry Stability Report 2023, Malaysia retained at the third position in 2022 after Saudi Arabia and Iran in terms of growth rate in domestic banking assets and share of global Islamic banking market. Bank Negara Malaysia reported that Islamic financing recorded 44.5 percent of the market share in 2022 with an annual growth of 10.8 percent as compared to only 1.3 percent for conventional financing (Bank Negara Malaysia, 2022). Due to its continuous potential growth, the Central Bank of Malaysia has introduced a new legal framework which is the Islamic Financial Services Act (IFSA) 2013 to ensure the Islamic finance industry becomes more dynamic, stable, and more competitive in Malaysia and globally.

One of the basic needs to have a decent life for humans is to have shelter and this is indicated as one of the important needs in the hierarchy of needs of a human. Indeed, in the *Maqasid Shariah*, protection of live is ranked the second among the five necessities of a man. Thus, a house is among the necessities that a person requires to lead life. To own a house, one must consider the affordability of funding and for practicing Muslims, the issue of *halal* financing is also important. From the state perspective, as argued by Ratcliffe et al. (2021), the financing of housing and real estate sectors is inextricably linked to the overall growth of the economy, because they are interconnected with many other sectors, and any changes in them have an impact on the entire economy.

The role of a tax system is not only limited to collect revenue for a government, but it is also a tool to help the government fulfils its objective effectively. The tax incentives for example help to attract foreign direct investment to the country and boost the Islamic finance market. Due to the importance of home financing especially Islamic home financing and tax incentives in a tax system, the objective of this paper is to examine the tax incentives for Islamic home financing provided by the Malaysian government for the most recent 5 years which is from 2019-2023. To fulfil this objective, this paper attempts to answer the following question, "What are the tax incentives for Islamic home financing in Malaysia for the period from 2019-2023?".

This paper is structured as follows. This section presents an introduction to the study as well as the research objective and research question. Next is the Literature Review and followed by the Method section which explains the method used in the study. The results and discussions are presented next and finally the conclusion section.

## LITERATURE REVIEW

### *Real property industry in Malaysia*

The national property market recorded transactions worth about RM 179 billion in 2022 in which the residential sector contributed around 62.5 percent in volume. The real property industry in Malaysia is expected to grow in 2023 especially for the residential sector despite lower economic growth projection (Business Times, 2023). Meanwhile, potential home buyers are cautious to purchase houses due to the high ownership cost. This is reflected in the decrease in the Sale Demand Index, which declined by 10.2 percent. The rising financing cost is also perhaps due to the increase in Overnight Policy Rate (OPR) by 25 points to 3 percent in May 2023 (Property Guru, 2023). In terms of financing the purchase of houses, it is reported that in 2022, to meet the household demand, Islamic financing reported an increase of 9.4 percent compared to 8.9 percent in 2021. Overall, around 60 percent of the household debt in 2022 is made up of housing debt (Bank Negara Malaysia, 2022).

Due to the concern of increasing housing cost and unaffordability to own houses, to date the government has been introducing some policy measures. Among the intervention on the housing price was the full exemption from Real Property Gains Tax (RPGT) on disposal of real property in the Budget 2007. However, this led to the increase in housing prices since no tax was imposed. Later, in 2010, the RPGT was re-instated to control the housing market. This indicates that tax policy has some implications on the housing market in Malaysia. A recent study by Norsiah et al., (2021) supports the tax policy implications on housing market in Malaysia. The study found that consumer burden and housing price index has a significant effect on direct tax rather than indirect tax at 1 percent level of significance. This implies that any tax policies that change the consumer purchasing power may affect the revenue collection by the government. It also suggests that the policy to shift the focus to indirect tax in 2015, does not have significant impact on the housing prices.

## *Islamic home financing*

Islamic financing is an alternative tool from the conventional product that is used to acquire assets. Like the conventional, Islamic home financing is a system of financing a home by banks and financial institutions except the Islamic home financing is without interest. This operation is based on profit and loss sharing or sale contract, and the risk is shared between the two parties (i.e., homebuyer and the financial institution).

The home purchase financing structures provided by banks and financial institutions that provide *Shari`ah*-compliant alternatives are: (1) the cost-plus sale (*Murabahah*); (2) the deferred payment sale (*bay' bithman ajil)*, which is common in Malaysia and Indonesia but infrequent elsewhere; (3) the buy-back leasing (*ijarah wa iqtina*); and (4) the diminishing partnership or diminishing *Musharakah* (*Musharakah mutanaqisa*).

## *Islamic home financing in Malaysia*

Malaysia has maintained its position as the global leader in Islamic finance, according to the latest report published in year 2021 by the Malaysia International Islamic Financial Centre in collaboration with the Islamic Corporation for the Development of the Private Sector (Gani and Bahari, 2021). Malaysia Islamic banking and finance, especially Islamic real estate finance, is one of the most renowned and established in the world and they have been in operation since the enactment of the Islamic Banking Act in 1983 and the establishment of Bank Islam Malaysia Berhad in the same year (Mukti, 2020). In Malaysia, there are three Shariah-compliant Islamic home financing instruments which are *Bai Bithaman Ajil, Musharakah Mutanaqisah*, *Tawaaruq* and *Al-ijarah Muntahia Bittamleek* (Bilal et al., 2019).

In a study by Ibrahim and Kamarudin (2018) on the type of Islamic home financing offered by Islamic banks in Malaysia between 2000-2016, suggests that most banks prefer the debt financing instrument and the commonly used are *Tawaaruq* and *Bai Bithaman Ajil.*

## *Taxation systems in Malaysia*

Before analyzing the tax incentives for Islamic home financing in Malaysia, it is worthy to understand the taxation system in Malaysia in brief. Generally, there are two types of taxes in Malaysia, first are the direct taxes and these are administered by the Inland Revenue Board and secondly the indirect taxes, which are governed by the Royal Customs and Excise Department of Malaysia. The direct taxes in Malaysia basically fall under the Income Tax, Petroleum Income Tax, Real Property Gains Tax and Stamp Duty.

The history of modern income taxation in Malaysia commenced in 1947, during which the British Administration introduced a modern taxation system in the then Persekutuan Tanah Melayu under the first Income Tax Ordinance. As for Sabah, the first Income Tax Ordinance was introduced in 1957 and much later, in 1961, in Sarawak. In 1968, the Malaysian Parliament enacted the Income Tax Act (ITA) 1967 which took effect from 1 January 1968.

Essentially, the scope of income that is taxed in Malaysia under the ITA 1967 is determined on territorial basis. However, certain industries such as the insurance services, banking and finance, and sea and air transport services, are taxed based on worldwide income basis. To date, most of the contribution from Federal Government revenue comes from tax collection which significantly comes from direct tax revenue. The average ratios from 2020 to 2022 between direct and indirect taxes are 74: 26 percent which indicate the reliance of Malaysia on direct tax rather than indirect tax. The largest contribution to direct tax revenue comes from corporate taxes, followed by individual taxes and petroleum sources as indicated in the following Figure 1 (Fiscal Outlook Ministry of Finance Malaysia, 2022).

Over the years, the Malaysian tax system has undergone several transformations. In 2000 for instance, the current year tax basis replaced the preceding tax basis as the first transition step to a full self-assessment tax system which requires voluntary tax compliance. In 2014, changes from imputation dividend income tax system to single tier dividend system were established. Later, the Goods and Services Tax (GST) was introduced on 1 April 2015 to replace the Sales Act 1972 and Services Tax Act 1975. The change in the politics landscape after the May 2018 election resulted in the abolishment of GST on 1 June 2018 and replaced by the re-introduction of Sales and Services Tax on 1 September 2018.

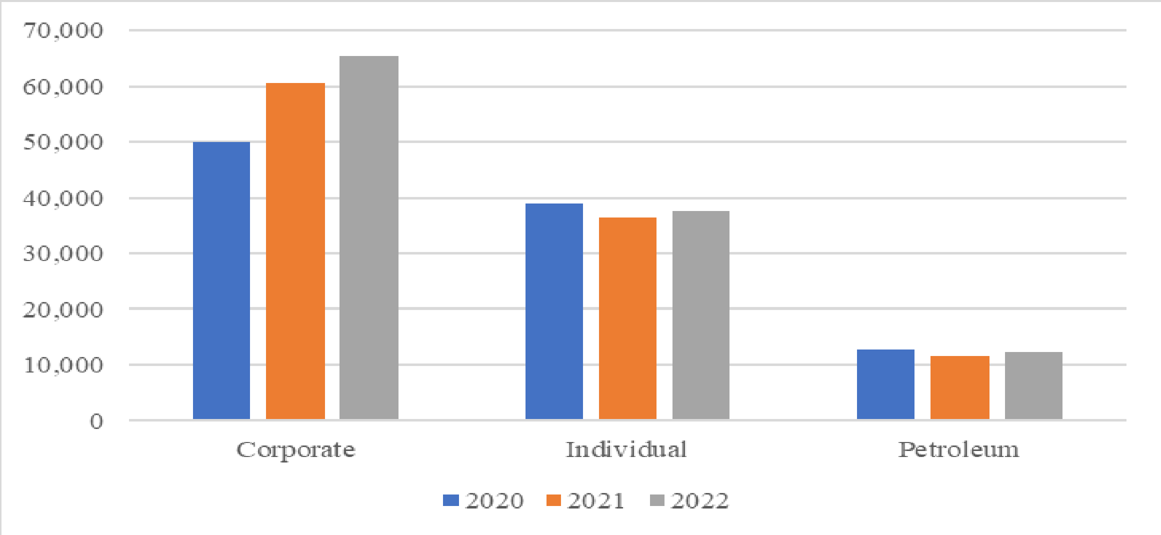


**Figure 1.** Federal Government Income from Direct Taxes (in Million Ringgit)

Regarding Islamic finance, the Malaysian government has applied the tax neutrality concept and tax incentives have been offered to this industry since the Budget 2007. Pursuant to Section 28 of the Income Tax Act 1967, the tax neutrality concepts treat Islamic finance like the interest-based transactions for tax purposes. Similar tax neutrality concept has been applied to the Real Property Gains Tax and Stamp duty to facilitate Islamic financing transactions.

### *The importance of tax incentives in a taxation system*

Tax incentives have been used by many countries throughout the world to promote economic growth and attract foreign direct investment to the host country. Despite the debatable effectiveness of tax incentives, Malaysia has a wide variety of incentives covering certain major industries. Tax incentives can be granted through income exemption or by way of allowances. Where incentives are given by way of allowances, any unutilised allowances may be carried forward indefinitely to be utilised against future statutory income except for certain incentives such as reinvestment allowance and investment allowance for approved service projects where a seven-year limitation applies.

For example, there are basically 12 main types of tax incentives under the Malaysian tax system as follows:

1. Pioneer status and investment tax allowance
2. Special incentives schemes
3. Regional operation
4. Financial services sectors
5. Petroleum sectors
6. Special economic regions
7. Information and communication technology
8. Green incentives
9. Biotechnology industry
10. Research and development
11. Other incentives.
12. Foreign tax credit

The following is the list of the top ten tax incentives claimed by companies in Malaysia in 2021.

**Table 1.** Ten most common types of incentives

| No. | Types of tax incentives | RM (Million) | Percentage |
|---|---|---|---|
| **1.** | Tax exempt dividend income | 75,530.13 | **51.82** |
| **2.** | Foreign income remittances (Paragraph 28, Schedule 6 of the ITA 1967) | 21,867.69 | **15.41** |
| **3.** | Income from business under special incentive scheme | 8,714.25 | **6.14** |
| **4.** | Income exempt (under Paragraph 127(3)(A) of the ITA 1967) | 7,897.97 | **5.56** |
| **5.** | Pioneer income | 4,429.98 | **3.12** |
| **6.** | Reinvestment allowance | 3,882.98 | **2.74** |
| **7.** | Investment tax allowance | 3,419.04 | **2.41** |
| **8.** | Assistance Funds received by employers under the Program Employment Retention (ERP) managed by the Social Security Organization (SOCSO | 2,394.76 | **1.69** |
| **9.** | Shipping income (Section 54A) | 1,830.74 | **1.29** |
| **10.** | Others | 13,935.37 | **9.82** |

Source: 2022 Taxation Statistics Book, Inland Revenue Board of Malaysia

The importance of tax incentives has been examined in past studies and many have conducted studies at companies' level. In a study by Abd Hamid (2015) for example, indicates that most SMEs in Malaysia are unsuccessful in utilizing the tax incentives available in the tax system because they did not make profit consistently. The tax incentives given at certain period of operation such as at the initial stage do not help them to improve their financial position. One of the reasons is due to the lack of monitoring by the relevant bodies that offered the tax incentives.

However, in another study by Abd Hamid et al (2016) suggests that tax incentives given on Islamic home financing have benefitted the taxpayers, homeowners, developers, and the Islamic finance industry. A similar support is also provided by Ahmad et al (2017) which found that, the increase in exporting activities of SMES are associated with export incentives provided by the Malaysian government such as, tax exemptions on the value of increased exports, Industrial Building Allowance (IBA), Duties and Sales Tax exemption, and Export Financing Facilities.

A review by Munongo et al (2017) suggests that while many studies indicate that tax incentives are important to attract investment, they are more effective when combined with other non-tax factors. In addition to that, applying tax incentives may bring benefit to the welfare of the residents that adopt the incentives but may contribute to costs implications to those residents in jurisdictions that do not adopt the tax incentives. The effectiveness of tax incentives for instance in research and development has also been examined recently in Argentina by Crespi et al (2018). The study found that tax incentive has been effective in increasing firms' innovation efforts. However, the effects vary depending on the type of innovation investment being subsidized, industrial sector, and size of the firm.

## METHODS

This paper applies the content analysis with descriptive analytical approach which examines the existing tax legislation and public rulings on incentives for home financing. Data was collected for a period of five years, from 2019 until 2023. These periods were analysed to understand the recent trends by the government to promote Islamic home financing as well as the Islamic finance industry in Malaysia. The data was extracted from the tax legislation, public rulings, yearly budget commentary and tax information produced by the Inland Revenue Board of Malaysia, Malaysian Institute of Certified Public Accountants (MICPA), Malaysian Institute of Accountants (MIA) and Chartered Tax Institute of Malaysia (CTIM).

## RESULTS AND DISCUSSIONS

Tax incentive is an important tool that has been used by the Malaysian government to promote Malaysia as the most preferred Islamic financial hub. This can be seen from various tax incentives for Islamic finance which have been offered by the Malaysian Government since the Budget 2007.

Below is the list of tax incentives given by the Malaysian government for the period from 2019 to 2023 which may relate to Islamic home financing as well since the taxation system in Malaysia treat Islamic finance instrument as equal to the conventional finance.

**Table 2.** Type of tax incentives related to Islamic home financing.

| No. | Type of tax incentives | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|---|
| 1. | Stamp duty exemption for the purchase of first residential property | √ | √ | √ | √ | √ |
| 2. | Redefinition of bankers for stamp duty purposes | √ | | | | |
| 3. | Double deduction on interest expense and all costs involved in obtaining loans to revive abandoned housing project | √ | √ | √ | √ | √ |
| 4. | Stamp duty exemption on loan agreement to revive abandoned housing project | | √ | √ | √ | √ |
| 5. | Stamp duty exemption on rent-to-own scheme | | √ | | | |
| 6. | Stamp duty exemption on restructuring or rescheduling of loan or financing agreement | | √ | √ | √ | √ |
| 7. | Remission of stamp duty for financing instruments | √ | √ | √ | √ | √ |
| 8. | Exemption of stamp duty for financing instruments | √ | √ | √ | √ | √ |
| 9. | Exemptions of Real property gains tax | √ | √ | √ | √ | √ |

Source: Budget commentary and tax information 2019-2023

The analyses indicate that tax incentives for Islamic home financing for the period 2019 until 2023, focused mostly on Stamp duty and Real Property Gains Tax. These tax incentives were also applicable to conventional loan product. Despite a wide range of tax incentives given for Islamic finance in Malaysia, not much is offered specifically to Islamic home financing. Most of the tax incentives for Islamic finance in Malaysia are centred around Islamic capital market product and securities such as *sukuk* and *halal* industry. The analyses also found that, the tax incentives given are similar throughout the five years and do not contain any new attraction for people to use Islamic home financing in buying houses. An exception perhaps is for the exemption of Stamp Duty (Exemption No.4 Order 2021) on any loan agreement with a licensed Islamic bank for the financing of purchasing a residential property under the Home Ownership Campaign 2021. However, the value of the residential property is more than RM300,000 and less than RM2.5 million and this exemption is also applicable to conventional home financing (Attorney General's Chambers, 2021).

## CONCLUSIONS

As a conclusion, despite shelter is a necessity for human and owning an affordable house in an issue in many countries such as Malaysia, not many tax incentives are provided for Islamic home financing. In the case of Malaysia, over the years since tax incentives were first given to Islamic finance industry, the tax incentives for Islamic finance are focused more on other Islamic finance products especially the Islamic capital market products such as *Sukuk* and the *Takaful* industry. Meanwhile, tax incentives for Islamic home financing in Malaysia are similar for the period 2019-2023 which focused mainly on Stamp duty and Real Property Gains Tax. Similar tax incentives are also applicable to the conventional loan due to the tax neutrality concept applied in Malaysia. Align with the government aspirations to develop Malaysia as the preferred Islamic financial hub, more attractive tax incentives on Islamic home financing should be offered. For instance, in 2009 and 2010, tax incentives were given to individual taxpayers who bought residental property from 10th March 2009 until 31 December 2010. During that period, the tax incentives were given in the form of RM10,000 tax deductibility for a period of 3 consecutive years under S46B of the Income Tax Act 1967 to individual taxpayers. In addition to that, not much has been discussed on the tax incentives for Islamic home financing in Malaysia as compared to other tax incentives provided in the Malaysian tax system which suggests opportunities for researchers to further explore in future studies of tax incentives.

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