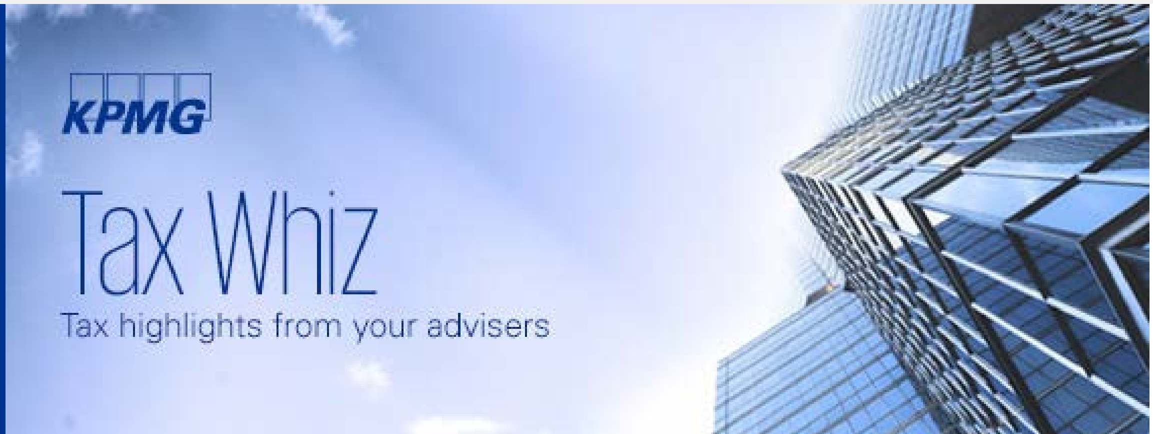
Subject: Tax Whiz | Malaysian Earning Stripping Rules ("ESR")



Important Link

- **Income Tax (Restriction on Deductibility of Interest) Rules 2019**

3 July 2019

Dear Valued Client / Business Associate,

Malaysian Earning Stripping Rules ("ESR")

The anticipated rules on Malaysian ESR, namely the Income Tax (Restriction on Deductibility of Interest) Rules 2019 ("the Rules") has been gazetted on 28 June 2019.

The Rules came into operation on 1 July 2019 and are applicable for the **basis period for a year of assessment ("YA") beginning on or after 1 July 2019**. It can be accessed via the above link.

Quick Recap of ESR

ESR is one of the Organisation for Economic Co-operation and Development ("OCED")'s action plans under the Base Erosion and Profit Shifting ("BEPS") project to tackle an area identified by the OECD as being prone to abuse i.e. excessive interest deduction.

The introduction of ESR is effected with the enactment of Section 140C in the Income Tax Act 1967 ("the ITA") to replace the thin capitalisation legislation which has been in abeyance since 2009. It brings significant impact on tax treatment of interest expense and potentially affects many corporations especially multinational groups.

Tai Lai Kok
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Outline of the Rules

Pursuant to the Rules, ESR is applicable to a specified person who has been granted any **financial assistance** in a **controlled transaction** in the basis period for a YA.

"Controlled transaction" shall be construed as a financial assistance —

(a) between persons one of whom has control over the other; or

(b) between persons both of whom are controlled by some other person.

Meaning of Control

≥ 20% of share capital +

1. Business operations of that person depends on the proprietary rights provided by the other person or a third person;
2. Business activities are specified by the other person, and the prices and other conditions relating to the supply are influenced by such other person or a third person; or
3. Where one or more of the directors or members of the board of directors are appointed by the other person or a third person.

De Minimis Threshold

ESR is applicable where:

Total interest expense on any financial assistance in a controlled transaction in the basis period for a YA > RM500,000

“Interest expense” and “financial assistance” are defined under Section 140C of the ITA.

Interest Expense

1. Interest on all forms of debt; or
2. Payments economically equivalent to interest (excluding expenses incurred in connection with the raising of finance)

Financial Assistance

1. Loan;
2. Interest bearing trade credit;
3. Advances;
4. Debt; or
5. Provision of any security or guarantee

Maximum Amount of Interest Deduction

ESR works by restricting tax deduction on interest expense to a percentage of a Company’s Earnings before Interest, Taxes, Depreciation and Amortisation (“EBITDA”).

The maximum amount of interest expense deductible from each business source for the basis period for a YA is 20% of tax-EBITDA.

The tax-EBITDA shall be ascertained in accordance with the following formula:

Tax-EBITDA

= **Adjusted income from business before restriction under ESR**

\+ **Qualifying deductions**

a. **Amount of expenditure incurred where double deduction has been claimed**

b. **Deduction made under Income Tax Rules issued under Section 154(1)(b) of the ITA**

\+ **Interest expense subject to ESR**

Carry Forward of Interest Expense Restricted

Interest expense in excess of 20% is allowed to be carried forward to deduct against the adjusted income of the Company for future years until it is fully utilised, subject to the substantial shareholding test as provided in the Rules.

Persons Excluded from ESR

ESR is not applicable to:

a. An individual;

b. The following financial institutions licensed under the Acts specified in the Rules:

   - Bank, investment bank, insurer and professional reinsurer
   - Islamic bank, takaful operator and professional retakaful operator
   - Labuan bank and investment bank
   - Labuan Islamic bank and Labuan Islamic investment bank
   - Labuan insurer and reinsurer including a Labuan captive insurance business
   - Labuan takaful operator and retakaful operator including a Labuan captive takaful business
   - Development financial institution

c. A construction contractor as defined under the Income Tax (Construction Contracts) Regulations 2007;

d. A property developer as defined under the Income Tax (Property Developer) Regulations 2007;

e. A person who has been granted an exemption under subsection 127(3)(b) or 127(3A) of the ITA.

Issues to Ponder

The Malaysian Inland Revenue Board has clarified in the Minutes of the Dialogues and Responses to the Joint Memorandum on Issues Arising from 2019 Budget Speech & Finance Bill 2018 that ESR is applicable to cross-border related party financial assistance only. However, the Rules do not seem to exclude domestic related party financial assistance arrangement from the application of ESR.

Further clarification is also required on what constitute “payments economically equivalent to interest” which is included in the definition of interest expense.

It remains to be seen whether the above issues will be addressed in the guidelines on ESR that are expected to be issued by the authorities following the gazette of the Rules.

Steps to be Taken

In view of the implementation of ESR for companies in respect of the basis period beginning on or after 1 July 2019, companies will need to commence assessing whether ESR is applicable and consider its tax impact. Where it is determined that ESR is applicable, it would be essential to understand, amongst others, the mechanism of ESR and the prescribed formula to ascertain the tax-EBITDA, in order to determine the amount of interest restricted.

After evaluating the tax impact, companies would have to review their debt profiles and look at options to restructure existing borrowings and to formulate strategies for future financial assistance, where necessary.

If you wish to discuss the impact of ESR on your company, please do not hesitate to contact any of our Executive Directors, Directors, Associate Directors or Managers whom you are accustomed to dealing with or who are responsible for the tax affairs of your organisation at the following telephone numbers for respective offices:

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Regards,

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For more information on our core service offerings, please contact:

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