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# Earning Stripping Rules

## Earning Stripping Rules – Heralding a New Regime, Ending the Deferment of Thin Capitalisation

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It has been proposed in Budget 2018 that Earning Stripping Rules ("ESR") will be introduced in Malaysia from 1 January 2019. ESR will replace the existing thin capitalisation rules which have been in abeyance since 2009. Once introduced these ESR will have a significant impact on the tax treatment of interest expenses.

A number of countries have already introduced ESR in various forms including Japan, the United Kingdom and the United States of America.

### Why Introduce ESR?

There have been concerns on the international front that some taxpayers may be adopting harmful tax practices. As such, the Organisation for Economic Co-operation and Development ("OECD") established the Base Erosion Profit Shifting ("BEPS") project which comprises 15 Action Plans. Of these Action Plans, BEPS Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, was launched to tackle an area identified by the OECD as being prone to abuse – i.e. excessive interest deductions. As the OECD notes the influence of tax rules on the location of debt within multinational tax groups has been established through studies and it is known that groups can easily multiply the level of debt at the level of individual group entities through intra group financing. Financial instruments can also be used to make payments which are economically equivalent to the interest but have a different legal form, therefore escaping restrictions in the deductibility of interest.

The UK introduced its version of ESR, called Corporate Interest Restriction ("CIR") rules, effective April 2017. In the UK Her Majesty's Revenue and Customs noted, when introducing the CIR rules, that risks to the tax base from interest deductions may arise in three basic scenarios:

(i) Groups placing higher levels of third party debt in high tax countries.

(ii) Groups using intra group loans to generate interest deductions in excess of the group's actual third party interest expense.

(iii) Groups using third party or intra group financing to fund the generation of tax exempt income.

## ESR vs Thin Capitalisation

ESR has similarities with thin capitalisation, as the objective of both rules is to determine whether the amount of debt and related interest expense are excessive. The key difference lies in the method of determining what would constitute excessiveness. Thin capitalisation uses a debt to equity ratio (Section 140A(4) of the Income Tax Act, 1967 used the expressions "financial assistance" and "fixed capital" in place of debt and equity), whereas ESR are based on the quantum of a company's interest expense over its Earnings Before Interest and Tax ("EBIT") or Earnings Before Interest, Tax, Depreciation and Amortisation ("EBITDA"). In this respect, ESR may be easier to implement than thin capitalisation given there is no requirement to define 'debt' or 'equity'. Thin capitalisation has particular definitional difficulties with hybrids; for instance, are redeemable preference shares, debt or equity?

Both ESR and thin capitalisation are in contrast to transfer pricing, which focuses on whether the rate of the interest is excessive by reference to the arm's length principle instead of whether the quantum of the interest expense is excessive.

## What Do ESR Entail?

The OECD report contains a framework for ESR which can be shown as follows:

**De Minimis Monetary Threshold**
To remove low risk entities

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**Fixed Ratio Rule**
Allows an entity to deduct net interest to a benchmark net interest/EBITDA ratio.

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**Group Ratio Rule**
Allows an entity to deduct net interest expense up to its group's net interest/EBITDA ratio.

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**Optional**
Carry forward disallowed interest / unused interest capacity and/ or carry back of disallowed interest

+

**Targetted Rules**
General interest limitation rules to address specific risk

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**Specific Rules**
To address issues raised by the banking and insurance sectors

This is just a framework and the Malaysian tax authorities will need to put the "flesh on the bones" in drafting the ESR.

## What Will ESR Apply To?

In principle, ESR are targetted at interest expenses. It would therefore be necessary to determine what should fall within the ambit of "interest" and this may include amounts economically similar to interest (e.g. interest element of a finance lease). ESR would be expected to apply to both conventional and Islamic financing arrangements. As an illustration, Japanese ESR, which were introduced in 2012, as well as applying to interest, include discounts on bills/notes, guarantee fees and other payments whose economic characteristics are equivalent to interest.

Generally, regard is had to interest expenses net of interest income. Using a net amount provides some measure of relief for group finance companies, which on a gross basis might have significant interest expenses and only modest earnings. The Japanese and UK ESR both work on a net interest expense basis. The use of net interest expense can also mitigate against the issue of double taxation where tax relief for an interest expense would otherwise be disallowed in one group company while the interest income is fully taxable in the recipient group company.

The OECD suggests that where an interest expense is below a pre-determined threshold, that amount should be excluded from the application of ESR. The rationale for this is that in the case of a relatively small interest expense, the risk of abuse is reduced. The UK ESR applies a de minimis limit of £2 million of net tax interest expense. As the UK's ESR operate on a group basis, the £2 million limit is applied on a group basis. The Japanese ESR, which work on a company by company basis, contain a two-limb de minimis rule. This rule applies where net interest payments to related parties do not exceed either (i) JPY10 million or (ii) 50% of total interest payments.

Although the Budget 2018 announcement makes reference to interest expense on loans between related parties, it should not - based on international experience - be assumed that ESR will be limited solely to related party interest.

## How Does The Fixed Ratio Rule Work?

Broadly, the amount of interest to be denied a tax deduction is ascertained by reference to a percentage of a company's EBIT or EBITDA. Budget 2018 indicates a percentage range of 10% to 30% although it is likely that a specific percentage will be used in the ESR rather than a range. Interest in excess of the prescribed ratio will not be deductible in the year it is incurred.

Whatever ratio is used, attention will need to be given to the meaning of EBIT or EBITDA as these are not defined under the Income Tax Act, 1967.

In Japan and the UK, the ESR are centered around what could be described as a "tax based EBITDA". In essence, this involves starting with adjusted income as disclosed in the tax computation before capital allowances, given that accounting depreciation and amortization are disallowed, and making further adjustments. The Japanese ESR use the term "Adjusted Taxable Income", rather than EBITDA, which means taxable income (calculated by not applying the provisions described in (i) below and treating all donations paid as tax deductible expenses) with an add back of items described in (ii) below. Note that while 'taxable income' can be negative, 'Adjusted Taxable Income' cannot.

(i) Main provisions not applied in calculating Adjusted Taxable Income:

- deduction for domestic dividends received
- foreign dividends exclusion
- certain valuation losses
- disallowance of deductions for income tax/foreign tax credited against corporation tax

- deduction of carried-forward tax losses
- deduction of dividends paid by tax qualified special purpose companies
- thin capitalisation regime
- earnings stripping regime

(ii) Items to be added back in calculating Adjusted Taxable Income:

- net interest payments to related persons
- tax deductible depreciation
- tax deductible bad debt losses

The UK's ESR adopt a not dissimilar approach.

## When Would The Group Ratio Rule Apply?

The OECD suggests the use of a Group Ratio Rule in addition to the Fixed Ratio Rule. A Group Ratio Rule is based on a ratio of group net interest expense to group EBITDA. This is an attempt to recognize that some groups, perhaps because of the nature of their particular industry, may be able to borrow larger amounts from third parties than would be allowed an interest deduction under the Fixed Ratio Rule. A Group Ratio Rule would therefore provide an alternative cap on interest expense which may allow group members to claim a higher interest expense than permitted under the Fixed Ratio Rule.

The issue of defining "group EBITDA" would need to be addressed if a Group Ratio Rule is intended. In addition, there should be a specific meaning assigned to a "group" and the extent to which this will be based on shareholding or extended to other forms of control.

## What Happens To Interest Expenses Disallowed Under ESR?

As business profits fluctuate, the OECD approach suggests that where a portion of an interest expense is disallowed under the ESR in a year, this could be carried forward or carried back and a deduction given in years where there is capacity. This would be the case where the interest expense for a year is lower than the capped amount under the Fixed Ratio Rule or the Group Ratio Rule. A company in its early years of operation may have a relatively high interest expense compared to its earnings. The ability to carry forward disallowed interest expense should mean the ESR would fit more readily with investment decisions which recognize that profitability takes time to achieve. The UK's ESR provide for a carry forward of disallowed interest expense. The Japanese ESR also allow for a carry forward although this is limited to seven years.

The OECD report indicates that a carry forward or carry back is optional. This will need particular attention in the Malaysian context given the tax legislation has traditionally only allowed the carry forward and not back of unutilised reliefs. The issue of the timing of incurrence of an expense would also need to be considered where an expense from one year is to be claimed as a tax deduction in another.

## How Would ESR Interact With Targetted Rules Aimed At Disallowing Interest Expenses?

The OECD recognises that in addition to ESR, a jurisdiction may have separate Targeted Rules which restrict deductions for interest expenses in specific cases. In this respect, Malaysia already has interest restriction rules as well as withholding tax on interest and the interaction with these will need to be considered in the formulation of Malaysia's ESR.

## What Is The Position Of The Banking and Insurance Sectors?

Due to the interest-centric nature of their businesses, the OECD recommends that specific rules be implemented for the banking and insurance sectors. In Malaysia, separate attention may be given to the banking sector as tax deductions on interest expenses are typically unavailable for the insurance sector.

## Will ESR Apply To Existing Financing Arrangements?

As part of the proposed introduction of ESR on 1 January 2019, the Malaysian tax authorities will need to consider whether there should be transitional provisions for existing financing arrangements and if so, to what extent. If considered appropriate, transitional provisions could include the grandfathering of existing loans subject to certain parameters. The UK, on the introduction of its ESR, provided grandfathering for existing finance leases as well as guarantees.

Consultation will undoubtedly be important. ESR have the tendency to become complex and affected businesses will need time to understand the proposals and to prepare for the implications. As the tax authorities will need to draft rules to implement ESR it is hoped there will be a consultation phase prior to implementation.

Entities who close their accounts on a date other than 31 December may have the added challenge of the ESR coming into force part way through their basis period. It is hoped that the ESR will include transitional provisions to ease in their introduction.

## Moving Towards ESR – What Should Taxpayers Do?

Given that ESR would be effective in less than 12 months, it is appropriate for entities to start looking at ratios of their interest expense to their tax based EBIT or EBITDA.

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