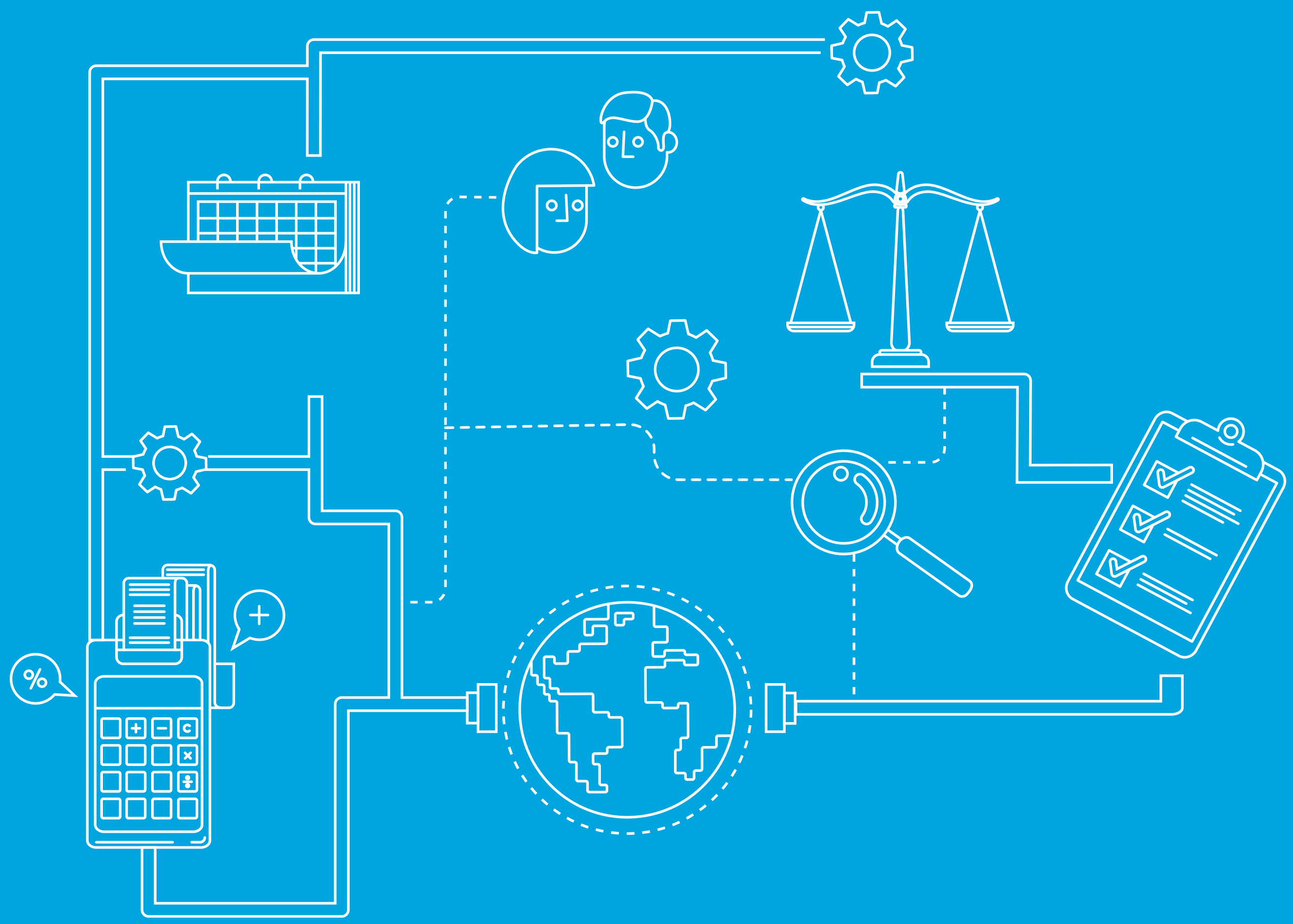
Technical update : Earning Stripping Rules



Income Tax (Restriction on Deductibility of Interest) Rules 2019

In Budget 2018, the Malaysian government announced the implementation of Earning Stripping Rules ("ESR") which is effective from 1 January 2019 to control excessive tax deduction on interest expenses between associated persons. The foundation of ESR is incorporated into the Malaysian income tax law through the addition of Section 140C of the Income Tax Act 1967 ("the Act").

Subsequently, the Income Tax (Restriction on Deductibility of Interest) Rules 2019 ("ESR Rules") was gazetted on 24 June 2019 which came into operation on 1 July 2019. The Inland Revenue Board ("IRB") further issued its Guidelines dated 5 July 2019 which provided clarifications and examples on ESR. Some key features are as follows:

Maximum Amount of Interest Expense Allowable

The maximum amount of interest expense referred to in Section 140C of the Act shall be an amount equal to 20% of the total amount of the Tax-EBITDA* of that person consisting of a business source for the basis period for a year of assessment ("YA") as ascertained in the ESR Rules.

** Negative Tax-EBITDA will be considered as NIL. In such case, all the interest expense subjected to Section 140C of the Act and ESR Rules would be restricted in ascertaining the adjusted business income.*

Application

- The ESR Rules shall apply to a person having interest expenses from financial assistance in a controlled transaction paid and payable to:- (please note that the following are only stated in the IRB's Guidelines and are not mentioned in the ESR Rules)
  - its associated person outside Malaysia;
  - its associated person outside Malaysia which operates through a permanent establishment in Malaysia;
  - a third party outside Malaysia where the financial assistance is guaranteed by its holding company or any other enterprises under the same MNE Group (regardless of the tax residence country of the guarantor).
- The total amount of interest expenses for such financial assistance exceeds RM500,000 (accumulated from all business sources) in the basis period for a YA.
- For the basis period beginning on or after 1 July 2019 and subsequent basis periods.
- Interest expense which is restricted in a YA can be carried forward and be deducted against adjusted income from the business for subsequent YAs (without time limit) unless there is a substantial shareholding change i.e. ordinary shareholders of more than 50% must remain the same on first and last day of the basis period.

Financial assistance	includes loan, interest bearing trade credit, advances, debt or the provisions of any security or guarantee
Interest expenses	means interest on all forms of debts or payments economically equivalent to interest which is deducted in ascertaining the adjusted income under the Act before any restriction under ESR (excluding expenses incurred in connection with the raising of finance)
Controlled transaction	shall be construed as a financial assistance – • between persons one of whom has control over the other; or • between persons both of whom are controlled by some other person ("the third person")
Control	can be direct, indirect or both as provided under Section 139 or Section 140A of the Act
MNE group	means a collection of enterprises related through ownership or control such that it is required to prepare consolidated financial statements for financial reporting purposes under the applicable accounting principles or would be so required if equity interest in any of its enterprises were traded on a public securities exchange
EBITDA	means earnings before interest, tax, depreciation and amortization
Tax-EBITDA	shall be ascertained in accordance to the following formula: **A** + **B** + **C** Where ▪ **A** is the amount of the adjusted income of the person from his sources consisting of a business for the basis period for a YA before any restriction on deductibility of interest under Section 140c of the Act is made ▪ **B** is the total amount of **qualifying deductions** allowed in ascertaining the amount of the adjusted income in A ▪ **C** is the total amount of interest expenses incurred in relation to the gross income of the person for any financial assistance in a controlled transaction from his sources consisting of a business for the basis period for a YA
Qualifying deduction	means:- • an amount equal to the amount of the expenditure incurred by a person computed in any deduction falling to be made under the Act where the amount of deduction is twice the amount of the expenditure incurred by a person; • any claim for deduction under any rules made under paragraph 154(1)(b) of the Act where the deduction is allowed for purposes of ascertaining the adjusted income of the person.

Persons excluded from ESR Rules

The ESR Rules does not apply to the following:

(1) An individual
(2) A construction contractor as defined under the Income Tax (Construction Contracts) Regulations 2007*
(3) A property developer as defined under the Income Tax (Property Developer) Regulations 2007*
(4) A person who is granted exemption under Paragraph 127(3)(b) or 127(3A) of the Act in respect of the adjusted income of the person
(5) A special purpose vehicle ("SPV") as defined under Section 60I(1) of the Act
(6) The following licensed financial institutions:
   - Bank, investment bank or Islamic bank
   - Insurer and professional reinsurer
   - Labuan bank, Labuan investment bank, Labuan Islamic bank or 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

** Where a person has other business income which is not specified above, that business income will be subjected to Section 140C of the Act & the ESR Rules.*

Based on the above, we provide an illustration of the application of the new ESR Rules.

- SubCo's adjusted income for YA 2020 is RM2.5 million
- SubCo incurs interest expense of RM850,000 during the basis period from 1 July 2019 to 30 June 2020 for YA 2020. The interest expense is derived from obtaining a loan from its foreign holding company ("HoldCo")
- The interest expense that is deductible against SubCo's business income before ESR restriction is RM650,000. The balance of RM200,000 is attributable to and deductible against its non-business income.
- SubCo incurs expenses of RM80,000 for hiring handicapped employees which qualifies for further deduction.

Computation of interest expenses restricted by ESR Rules

	RM	
Adjusted income from business	2,500,000	(A)
<u>Add:</u> Interest expense from HoldCo that is deductible against business income	650,000	(C)
Further deduction	80,000	(B)
Tax-EBITDA	3,230,000	(X)
Maximum amount of interest deduction (20% x X)	646,000	(Y)
Interest expense deductible against business income before ESR	650,000	(Z)
Interest expense restricted by ESR which can be carried forward to YA 2021 (Z – Y)	4,000	

Should you have any queries or require more information, please do not hesitate to contact us.

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