



Taxavvy

1 July 2019 | Issue 9-2019

Earnings Stripping Rules



Earnings Stripping Rules ("ESR")

The implementation of ESR which limits interest deduction for financial assistance between related persons was first announced during Budget 2018. Its implementation was confirmed when a new Section 140C was inserted into the Income Tax Act 1967 ("Act") via the Finance Act 2018. Although Section 140C was supposed to take effect from 1 January 2019, its implementation requires further Rules to be prescribed by the Minister of Finance.

The prescribed Rules, i.e. the Income Tax (Restriction on Deductibility of Interest) Rules 2019 ("ESR Rules") have been gazetted on 28 June 2019.

Key features

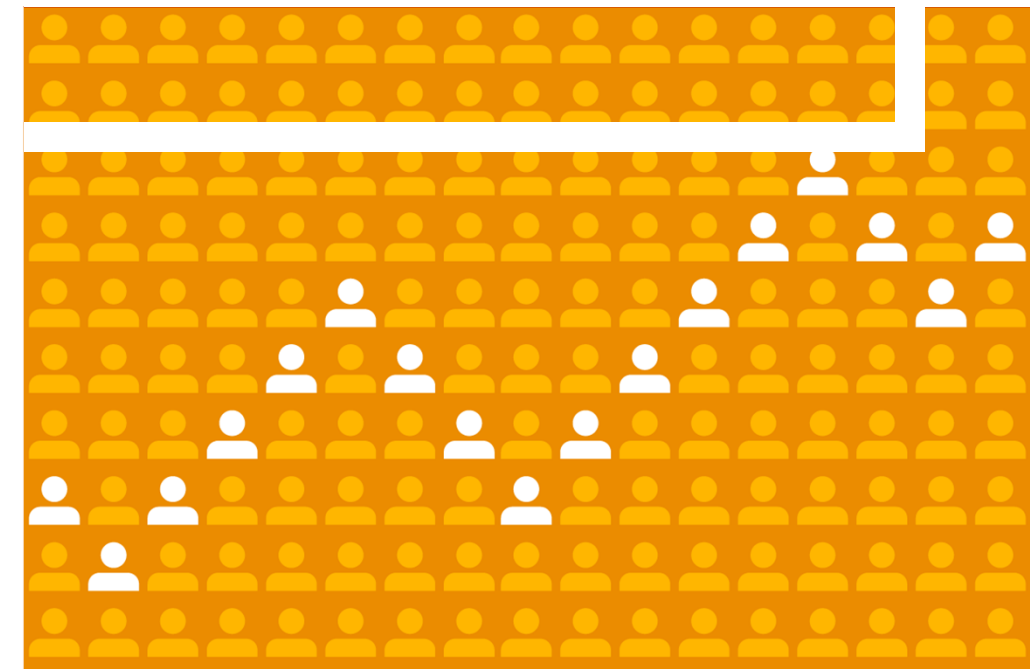
Key features of ESR based on Section 140C and the ESR Rules are as follows:

Commencement date	Basis period for a year of assessment (YA) beginning on or after 1 July 2019.
Scope	Interest expense in connection with or on any financial assistance in a controlled transaction granted directly or indirectly to the person.
<i>De minimis</i> rule	ESR is not applicable where the interest expense is not more than RM500,000 in a basis period for a YA.
Maximum amount of interest deduction	20% of Tax-EBITDA.
Carry forward rules	<p>Interest expense which is restricted in a YA can be carried forward and deducted against adjusted income from the business for subsequent YA(s).</p> <p>The eligibility to carry forward is not subject to any time-limited rule such as the 7-year limit that is currently placed on unabsorbed business losses. However, it is subject to satisfying the substantial shareholders continuity test.</p>

Interest expense	<ul style="list-style-type: none"> (i) Interest on all forms of debt; or (ii) Payments economically equivalent to interest (excluding expenses in connection with the raising of finance).
Financial assistance	Includes loan, interest bearing trade credit, advance, debt or the provision of security or guarantee.
Controlled transaction	<p>Financial assistance between “related persons”; i.e. between:</p> <ul style="list-style-type: none"> • Persons one of whom has control over the other; or • Persons both of whom are controlled by a third person.
Tax-EBITDA	$ \begin{aligned} & \text{Tax-EBITDA} \\ & = \\ & \text{Adjusted income from business} \\ & + \\ & \text{Special deductions given under specific rules or provisions, i.e. deductions equivalent} \\ & \text{to 200\% of amount incurred and deduction under rules made under Section 154(1)(b)} \\ & \text{of the Act in ascertaining adjusted income} \\ & + \\ & \text{Total interest expense incurred for the business which is in connection with or on} \\ & \text{financial assistance from controlled transactions} \end{aligned} $

The Inland Revenue Board has previously shared that the scope of ESR shall be limited to cross-border financial assistance. In other words, financial assistance from domestic related persons are excluded from the scope of ESR.

However, the ESR Rules are currently silent on the availability of this important exclusion.



Persons specifically excluded from the ESR Rules

The ESR Rules shall not apply to the following persons:

1. An individual
2. A property developer as defined under the Income Tax (Property Developer) Regulations 2007
3. A construction contractor as defined under the Income Tax (Construction Contracts) Regulations 2007
4. A person who has been granted exemption under Section 127(3)(b) or Section 127(3A) of the Act in respect of the adjusted income of the person
5. The following licensed financial institutions:
 - Bank, investment bank, insurer and professional reinsurer
 - Islamic bank, takaful operator and professional retakaful operator
 - Labuan bank and Labuan 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



Illustration 1: Computation of interest disallowed under ESR

Scenario

- SubCo incurs total interest expense of RM700,000 during the basis period from 1 July 2019 to 30 June 2020 for YA 2020. The interest expense arises from a loan obtained from its holding company (“HoldCo”).
- Interest expense that is deductible against SubCo’s business income before ESR is RM600,000. The balance of the interest expense of RM100,000 is attributable to and deductible against its non-business income.
- SubCo’s adjusted income from its business for YA 2020 is RM1.5 million.
- SubCo incurs expenses of RM200,000 in respect of sponsorship of scholarship which qualifies for a double deduction.

Computation of interest expense restricted by ESR

	YA 2020 (RM)	
Adjusted income from business	1,500,000	
<u>Add</u>		
• Double deduction (RM200,000 x 200%)	400,000	
• Interest expense from HoldCo that is deductible against income from business	<u>600,000</u>	
Tax-EBITDA	<u>2,500,000</u>	(A)
Maximum amount of interest deduction (20% x A)	500,000	(B)
Interest expense deductible against business income before ESR	<u>600,000</u>	(C)
Interest expense restricted by ESR which can be carried forward to YA 2021 (C - B)	<u>100,000</u>	



Carry forward rules

Interest expense of a company which is restricted by ESR (“unabsorbed interest expense”) qualifies to be carried forward and deducted against income from subsequent YA(s).

To qualify, a company must ensure that its ordinary shareholders for the subsequent YA remains substantially the same at these two dates:

- the first day; and
- the last day,

of the basis period for the subsequent YA (the “substantial ordinary shareholding continuity test”).

If the ordinary shareholders at these two dates do not remain substantially the same, the unabsorbed interest expense is to be permanently disregarded.

The ordinary shareholders are considered to remain substantially the same on the above two dates if:

- More than 50% of the paid-up capital in respect of ordinary shares of the company are held by or on behalf of the same persons; and
- More than 50% of the value of the allotted shares in respect of ordinary shares of the company are held by or on behalf of the same persons.

Illustration 2: Substantial ordinary shareholding continuity test

Following from Illustration 1, SubCo’s eligibility to carry forward the unabsorbed interest expense from YA 2020 is illustrated as follows:

	Scenario A	Scenario B
On 1 July 2020	51% paid up capital and value of allotted ordinary shares are held by Mr A.	51% paid up capital and value of allotted ordinary shares are held by Mr A.
On 30 June 2021	51% paid up capital and value of allotted ordinary shares are held by Mr A.	49% paid up capital and value of allotted ordinary shares are held by Mr A.
Ordinary shareholding remains substantially the same?	Yes. Mr A continues to hold more than 50%.	No. Mr A no longer holds more than 50%.
Can SubCo carry forward unabsorbed interest expense to YA 2021 and subsequent YAs?	Yes.	No. The unabsorbed interest expense of RM100,000 is permanently disregarded.

Illustration 3 – Utilisation of unabsorbed interest expense

Scenario

- Continuing from Illustrations 1 and 2 and assuming SubCo meets the substantial ordinary shareholding continuity requirement on 1 July 2020 and 30 June 2021.
- SubCo's Tax-EBITDA for YA 2021 is RM3.25 million.
- SubCo's interest expense arising from the loan from HoldCo that is deductible against business income before ESR for YA 2021 is RM700,000.

Treatment of unabsorbed interest expense carried forward to YA 2021

	YA 2021	
	(RM)	(RM)
Tax-EBITDA		3,250,000 (A)
Maximum amount of interest deduction (20% x A)		650,000 (B)
Interest expense deductible against business income before ESR		
- Unabsorbed interest expense brought forward from YA 2020	100,000	
- Current year interest expense	700,000	
- Amount available for absorption	<u>800,000 (C)</u>	
Total interest expense restricted by ESR which can be carried forward to YA 2022, subject to the substantial ordinary shareholding continuity test (C - B)		<u>150,000</u>

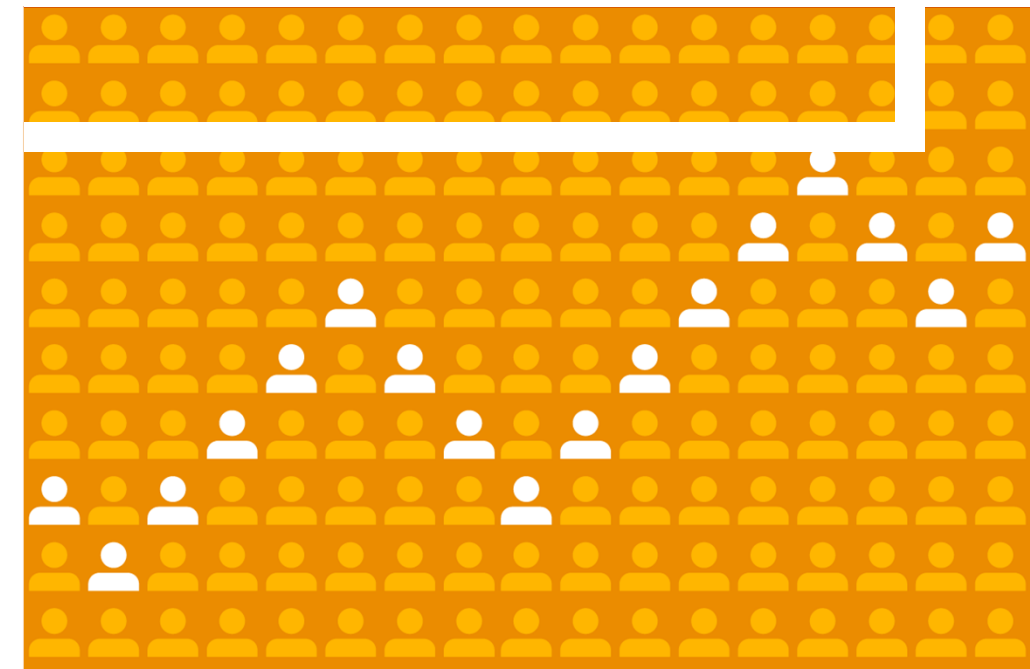


Observations

We understand that a guideline on ESR will be issued by the Inland Revenue Board to further explain the ESR Rules. Pending the issuance of the guideline and further clarification from the Ministry of Finance and/or Inland Revenue Board, the following are issues that remain outstanding at this point in time:

- **Application to domestic financial assistance**
Contrary to the understanding given previously by the Inland Revenue Board at some public forums that the ESR will only apply to cross-border related party financial assistance, the gazetted ESR Rules do not seem to exclude domestic related party financing arrangements.
- **Exclusion of persons granted exemption under Sections 127(3)(b) and 127(3A) of the Act**
We note that this exclusion applies to exemptions in respect of adjusted income of the person. This is very narrow as most exemptions under the above sections are granted at the statutory income instead of adjusted income level. This raises a question on whether this is indeed the intention of the Government?
- **Scope of interest**
The inclusion of “payments economically equivalent to interest” as interest requires further guidance from the authorities for better clarity and improved compliance.
- **Financial assistance**
This is extended to cover “provision of security or guarantee”. Further explanation from the authorities is required on whether this is meant to limit the deduction of interest expense on third party loans which are guaranteed by a related party.
- **Grandfathering rules**
The ESR Rules do not provide any grandfathering rules. Therefore, the deductibility of interest expense (which is scoped under the ESR Rules) incurred by persons with a basis period which begins on or after 1 July 2019 will be subject to the ESR Rules irrespective of whether the underlying financial assistance was obtained prior to 1 July 2019.

With the ESR Rules coming into effect on 1 July 2019, taxpayers should review all their financing arrangements to ascertain the scope of arrangements falling under the ESR Rules, evaluate the efficiency of the arrangements and determine the tax impact.



Connect with us

Kuala Lumpur

Jagdev Singh

jagdev.singh@pwc.com
+60(3) 2173 1469

Penang & Ipoh

Tony Chua

tony.chua@pwc.com
+60(4) 238 9118

Johor Bahru

Benedict Francis

benedict.francis@pwc.com
+60(7) 218 6000

Melaka

Benedict Francis

benedict.francis@pwc.com
+60(7) 218 6000

Tan Hwa Yin

hwa.yin.tan@pwc.com
+60(6) 283 6169

Kuching

Bryan Chen

bryan.chen@pwc.com
+60(82) 527 218

Labuan

Jennifer Chang

jennifer.chang@pwc.com
+60(3) 2173 1828

Corporate Tax Compliance & Advisory

Consumer & Industrial Product Services

Margaret Lee

margaret.lee.seet.cheng@pwc.com
+60(3) 2173 1501

Steve Chia

steve.chia.siang.hai@pwc.com
+60(3) 2173 1572

Emerging Markets

Fung Mei Lin

mei.lin.fung@pwc.com
+60(3) 2173 1505

Energy, Utilities & Mining

Lavindran Sandragasu

lavindran.sandragasu@pwc.com
+60(3) 2173 1494

Financial Services

Jennifer Chang

jennifer.chang@pwc.com
+60(3) 2173 1828

Technology, Media, and Telecommunications

Heather Khoo

heather.khoo@pwc.com
+60(3) 2173 1636

Specialist services

Corporate Services

Lee Shuk Yee

shuk.yee.x.lee@pwc.com
+60(3) 2173 1626

Global Mobility Services

Sakaya Johns Rani

sakaya.johns.rani@pwc.com
+60(3) 2173 1553

Hilda Liow

hilda.liow.wun.chee@pwc.com
+60(3) 2173 1638

International Tax Services / Mergers and Acquisition

Gan Pei Tze

pei.tze.gan@pwc.com
+60(3) 2173 3297

Tax Reporting & Strategy

Pauline Lum

pauline.ml.lum@pwc.com
+60(3) 2173 1059

Dispute Resolution

Tai Weng Hoe

weng.hoe.tai@pwc.com
+60(3) 2173 1600

Indirect Tax

Raja Kumaran

raja.kumaran@pwc.com
+60(3) 2173 1701

Yap Lai Han

lai.han.yap@pwc.com
+60(3) 2173 1491

Chan Wai Choong

wai.choong.chan@pwc.com
+60(3) 2173 3100

Tax Technology

Yap Sau Shiung

sau.shiung.yap@pwc.com
+60(3) 2173 1555

Transfer Pricing

Jagdev Singh

jagdev.singh@pwc.com
+60(3) 2173 1469

China Desk

Lorraine Yeoh

lorraine.yeoh@pwc.com
+60(3) 2173 1499

Japanese Business Consulting

Yuichi Sugiyama

yuichi.sugiyama@pwc.com
+60(3) 2173 1191

Clifford Yap

clifford.eng.hong.yap@pwc.com
+60(3) 2173 1446



www.pwc.com/my/tax

TaXavy is a newsletter issued by PricewaterhouseCoopers Taxation Services Sdn Bhd. Whilst every care has been taken in compiling this newsletter, we make no representations or warranty (expressed or implied) about the accuracy, suitability, reliability or completeness of the information for any purpose. PricewaterhouseCoopers Taxation Services Sdn Bhd, its employees and agents accept no liability, and disclaim all responsibility, for the consequences of anyone acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it. Recipients should not act upon it without seeking specific professional advice tailored to your circumstances, requirements or needs.

© 2019 PricewaterhouseCoopers Taxation Services Sdn Bhd. All rights reserved. "PricewaterhouseCoopers" and/or "PwC" refers to the individual members of the PricewaterhouseCoopers organisation in Malaysia, each of which is a separate and independent legal entity. Please see www.pwc.com/structure for further details.