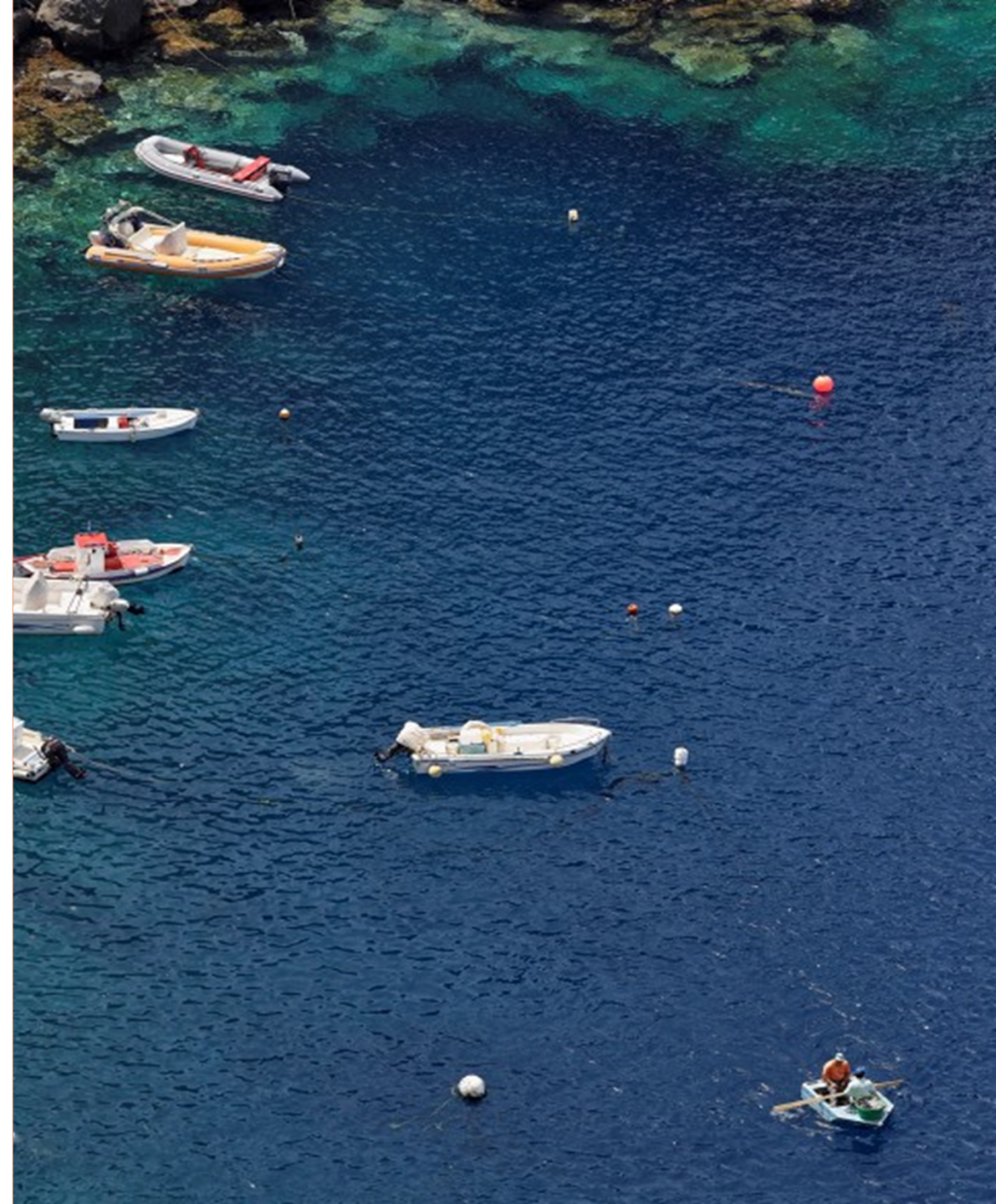




# Taxavvy

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## Earnings Stripping Rules - Guidelines



## Guidelines on the Earnings Stripping Rules (“ESR”)

[TaXavvy 9-2019](#) had commented on the Income Tax (Restriction on Deductibility of Interest) Rules 2019 (“ESR Rules”) which was gazetted on 28 June 2019.

Subsequent to this, the Restriction on Deductibility of Interest Guidelines [section 140C, Income Tax 1967] (“the ESR Guideline”) has been issued by the Inland Revenue Board on 5 July 2019 to provide guidance on the ESR Rules.

This issue of the TaXavvy summarises the key points and clarification provided in the ESR Guideline.



### Scope of the ESR - whether the scope is limited to cross-border related party transactions?

#### ESR Rules

Apply to a person who has been granted any financial assistance in a controlled transaction and the total amount of any interest expense for all such financial assistance exceeds RM500,000 in the basis period for a year of assessment.

#### ESR Guideline

The Guideline clarifies that the ESR Rules will only apply to interest expenses from financial assistance which is paid or payable to:

- (i) its associated person outside Malaysia;
- (ii) its associated person outside Malaysia which operates through a permanent establishment in Malaysia;
- (iii) 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)

#### Our comments

Despite the wide scope of the provisions of the ESR Rules (which cover both domestic and cross-border related party financial assistance), the ESR Guideline has narrowed the scope to cross-border related party financial assistance.

## Interest expense - what are “payments economically equivalent to interest”?

### ESR Rules

“Interest expenses” is defined in Section 140C of the Income Tax Act 1967 (the Act) as:

- (a) interest on all forms of debt; or
- (b) payments economically equivalent to interest (excluding expenses incurred in connection with the raising of finance)

### ESR Guideline

- Provides the meaning of “interest” as “the return or compensation for the use or retention by a person of a sum of money belonging to or owed to another person”.
- “Interest expenses” excludes:
  - (a) any interest expenses incurred in connection with the raising of finance (e.g. guarantee fee); or
  - (b) any interest expenses incurred which is not allowable in ascertaining the adjusted income under the Act before any restriction on the deductibility of interest is made under section 140C of the Act of a person from the business source.
- “Payment economically equivalent to interest” includes:
  - (a) profit and loss sharing concept used in Islamic financing (section 2(7) of the Act); and
  - (b) any discount or premium (capital gain / loss) on issuing or subscribing debt instruments that will be amortised through the interest expenses.

In determining whether a payment is economically equivalent to interest, focus is placed on the payment’s economic substance rather than its legal form.

### Our comments

- Whilst the ESR Guidelines has provided items that can be included as “payments economically equivalent to interest”, it is noted that the examples given are not exhaustive.
- It is pleasing to note that unlike the best practices rule under BEPS Action Plan 4 [Limiting Base Erosion Involving Interest Deductions and Other Financing Payments], expenses incurred in connection with the raising of finance is specifically excluded.
- Taxpayers should take note that the Inland Revenue Board will be guided by “substance over form” in determining if an item falls within “payments economically equivalent to interest”.

## What constitutes a “controlled transaction” for the purposes of ESR?

### ESR Rules

“Control” is defined under subsection 140A(5A) of the Act as referring to “persons one of whom owns shares of the other person, or a third person who owns shares of both persons, where the percentage of the share capital held in either situation is 20% or more and -

- a) the business operations of that person depends on the proprietary rights, such as patents, non-patented technological know-how, trademarks, or copyrights, provided by the other person or a third person;
- b) the business activities, such as purchases, sales, receipt of services, provision of services, of that person 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
- c) where one or more of the directors or members of the board of directors of a person are appointed by the other person or a third person.”

### ESR Guideline

Provides examples that illustrate the abovementioned scenarios (a) to (c).

### Our comments

Taxpayers should take note of the shareholding threshold of 20% and the requirement to also meet one or more of the stipulated scenarios above to ensure that financial assistance which is caught under the ESR Rules is taken into account in computing the amount of interest restriction under the ESR Rules.



## What falls under the meaning of “financial assistance”?

### ESR Rules

Financial assistance is defined in Section 140C of the Act as: “includes loan, interest bearing credit, advances, debt or the provision of security or guarantee”.

### ESR Guideline

In respect of “provision of security or guarantee”, the Guideline states in paragraph 4(b)(iii) that the following would fall under the scope of the ESR Rules:

“a person having interest expenses from financial assistance from 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)”

### Our comments

Based on the above explanation provided in the ESR Guideline, the ESR Rules is not restricted to only cross-border related party financial assistance. It extends to loans provided by third parties outside Malaysia if the loan is guaranteed by another company in the same MNE Group.

## De Minimis Rule and maximum amount of interest deduction

### ESR Rules

ESR is applicable where total interest expense on all financial assistance from controlled transactions exceeds RM500,000.

### ESR Guideline

The Guideline has provided an example to illustrate the following in relation to a taxpayer who has more than one or multiple business sources:

- The cumulative interest expense from all business sources is used to test whether the threshold of RM500,000 has been exceeded.
- The maximum amount of interest restricted (i.e. 20% on Tax-EBITDA) is computed separately for each business source.

## Persons specifically excluded from the ESR Rules

### ESR Rules

The Rules provide a list of exclusions from application of the ESR Rules (please refer to [TaXavvy 9-2019](#)).

### ESR Guideline:

- i. **Added to the listing of exclusions:** a special purpose vehicle (SPV) established solely for the issuance of sukuk (subsection 60I(1) of the Act). This is not provided in the ESR Rules.
- ii. **Omitted from the listing of exclusions:** a person granted an exemption under paragraph 127(3)(b) or subsection 127(3A) of the Act in respect of the adjusted income of the person.
- iii. **Clarified** that where a person carrying on a business of a construction contractor or property developer which are subject to Income Tax (Construction Contracts) Regulations 2007 and Income Tax (Property Developers) Regulations 2007 respectively, has other business income not covered under those Regulations, the other business income would not be excluded from the ESR Rules.

### Our comments

- In relation to (i) above, the SPVs are already exempted from the compliance requirements required under the Act pursuant to section 60I(2) of the Act.
- Further clarification is required from the authorities that the exemption referred to in (ii) above is indeed for exemption at adjusted income and not statutory income level.



## Qualifying deductions to be added back in determining Tax-EBITDA

### ESR Rules

Tax-EBITDA = Adjusted income from business  
+ Qualifying deduction  
+ Total amount of interest expense 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 year of assessment.

Qualifying deduction means:

- (a) an amount equal to the amount of expenditure incurred by a person computed in any deduction falling to made under the Act where the amount of deduction is twice the amount of the expenditure incurred by a person;
- (b) 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

### ESR Guideline

An illustration on the computation of Adjusted income has been provided in Annex A to the Guideline. It is noted on page 18 of the computation that Qualifying deduction comprises:

- (i) special deduction and other claims
- (ii) further deduction
- (iii) double deduction
- (iv) exemption provided under subsection 154(1)(b)



## Qualifying deductions to be added back in determining Tax-EBITDA (continued)

### Our comments

Based on the illustration on page 18, it appears that the amount of expense incurred to be added back as Qualifying deduction is as follows:

	<u>% of expenses</u> <u>incurred</u>	
(i) Special deduction	100%	[e.g. Income Tax (Deduction for Audit Expenditure) Rules 2006 [PU (A) 129/2006]]
(ii) Further deduction	100%	[e.g. Income Tax (Deduction for Promotion of Exports ) Rules 2002 [PU (A) 115/2002]]
(iii) Double deduction	200%	[e.g. Section 34(6)(ma) of the Act in relation to expenditure incurred for purpose of obtaining certification for recognized quality standards and halal certification]

Further clarification from the authorities is required as the meaning of Qualifying deduction in the ESR Rules may not be entirely clear.



## 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



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