

25 JULY 2019

Earning Stripping Rules: Restriction on Interest Deduction

In addition to the Income Tax (Restriction on Deductibility of Interest) Rules 2019 (**Rules**), on 5.7.2019, the Inland Revenue Board of Malaysia (**IRB**) published its “Guidelines on Restriction on Deductibility of Interest” (**Guidelines**). The Rules supplement Section 140C of the Income Tax Act 1967 (**ITA**), which came into effect on 1.1.2019. The Guidelines provide some insights into the interpretation of the Rules by the IRB and how taxpayers can expect the Rules on the interest restriction to be applied. However, the Guidelines have no legal effect.

Since the introduction of Section 140C, there has been much speculation as to the extent to which Malaysia would adopt the recommendations of the Organisation for Economic Co-operation and Development (**OECD**) in implementing Earning Stripping Rules (**ESR**) to restrict the deduction of interest paid between related persons in order to prevent artificial profit shifting. Our Tax e-Alert dated 31.1.2019, [Insights Into Earning Stripping Rules](#), highlights the key OECD recommendations on ESR.

Effective Date

The restriction on the deductibility of interest only applies in respect of the basis period beginning on or after 1.7.2019. Where the basis period of a person begins before 1.7.2019, the interest restriction is inapplicable.

Scope of Application

Section 140C and the Rules only apply to a taxpayer who has interest expenses from financial assistance that are paid or payable to:

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- (a) An associated person outside Malaysia (including where the associated person operates through a permanent establishment in Malaysia); or
- (b) A third party outside Malaysia where the financial assistance is guaranteed by its holding company or any other enterprises under the same multinational enterprise (MNE) group (irrespective of the tax residence country of the guarantor).

The Guidelines appear to limit the scope of the restriction on the deductibility of interest to cross-border transactions, and not domestic financing arrangements. However, the wording of Section 140C does not seem to restrict its applicability to domestic transactions as well. This could be a thorny issue moving forward if the IRB decides to expand the scope of Section 140C to cover domestic financing arrangements.

***De minimis* Threshold**

Interest restriction is inapplicable where the total amount of interest expense in respect of all financial assistance is equal to, or less than, RM500,000 in a year of assessment (**YA**).

Where a person has multiple business sources, the interest expense in respect of all business sources is taken into consideration for the purpose of determining whether the threshold is met. However, the calculation of interest restriction is made separately in respect of each business source.

Exceptions

The Rules do not apply to selected classes of taxpayers, namely:

- Individuals
- Banks
- Insurers
- Development financial institutions
- Construction contractors
- Property developers.

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Notably, the Guidelines provide that interest restriction also does not apply to a special purpose vehicle, although this is not expressly stated in the Rules. Also, under the Rules, the restriction on the deductibility of interest does not apply to taxpayers who have been granted tax exemption under Section 127(3)(b) or 127(3A) of the ITA.

Maximum Amount of Interest Expense

The maximum amount of interest expense allowed is 20% of the tax-EBITDA (earnings before interest, taxes, depreciation and amortisation) of a taxpayer from each of his sources consisting of a business for a YA.

The tax-EBITDA is determined as follows:

$$A + B + C$$

Where:

- (a) "A" is the amount of adjusted income of a taxpayer before any restriction on deductibility of interest;
- (b) "B" is the total amount of qualifying deductions allowed; and
- (c) "C" is the total amount of interest expense incurred in relation to the gross income of the taxpayer for any financial assistance in a controlled transaction.

Carrying Forward of Interest

Excess interest expense can be carried forward and deducted against the adjusted income of the taxpayer for subsequent YAs until the whole amount of the excess has been fully utilised. However, this is subject to a shareholding test, where the shareholders of the taxpayer on the first and last day of the next YA must remain substantially the same.

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Conclusion

In light of the Rules, taxpayers in Malaysia — especially those with cross-border financing arrangements — should ascertain whether their interest expense exceeds 20% of their tax-EBITDA. Additionally, they should also ensure compliance with the ITA and the Rules.

Taxpayers may need to reconsider and restructure their financing arrangements but, in so doing, must be wary of the tax avoidance provision. This is because of late, officers of the IRB have invoked the general anti-avoidance provision to vary or disregard an arrangement which they deem to have a tax benefit for the taxpayer. If taxpayers find the IRB's interpretation of the Rules to be inconsistent with the ITA or the wording of the Rules itself, then they ought to seek further legal advice to preserve their rights.

If you have any queries on the application of Section 140C and the Rules to your financing arrangements or the deductibility of financing costs generally including interest, please contact Tax, SST & Customs partners, **Datuk D P Naban** and **S Saravana Kumar**, at tax@lh-ag.com

For queries on conventional corporate financing matters including documentations for loans and bonds, please contact Corporate Finance partner, **Ong Eu Jin**, at oej@lh-ag.com

For Islamic corporate financing matters, please contact Islamic Finance partner, **Megat Hizaini Hassan**, at mh@lh-ag.com

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