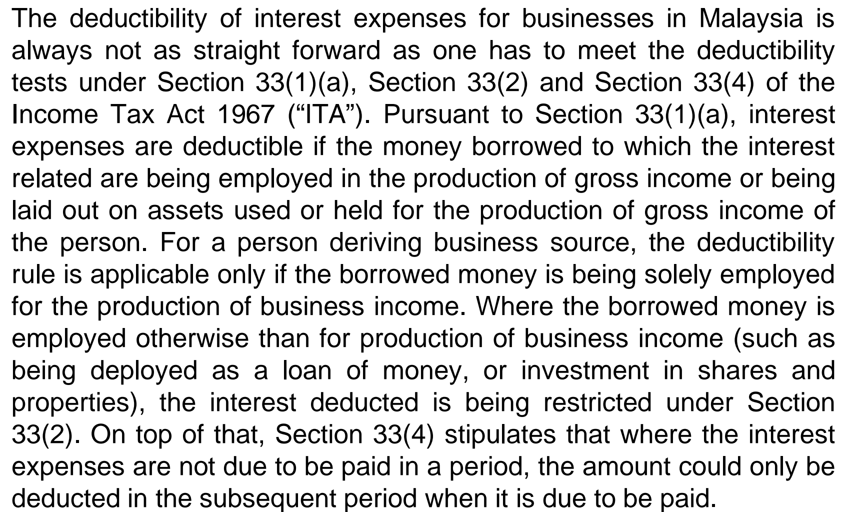
Crowe Horwath™

Earning Stripping Rules to replace Thin Capitalisation

Audit / Tax / Advisory

Smart decisions. Lasting value.



The deductibility of interest expenses for businesses in Malaysia is always not as straight forward as one has to meet the deductibility tests under Section 33(1)(a), Section 33(2) and Section 33(4) of the Income Tax Act 1967 ("ITA"). Pursuant to Section 33(1)(a), interest expenses are deductible if the money borrowed to which the interest related are being employed in the production of gross income or being laid out on assets used or held for the production of gross income of the person. For a person deriving business source, the deductibility rule is applicable only if the borrowed money is being solely employed for the production of business income. Where the borrowed money is employed otherwise than for production of business income (such as being deployed as a loan of money, or investment in shares and properties), the interest deducted is being restricted under Section 33(2). On top of that, Section 33(4) stipulates that where the interest expenses are not due to be paid in a period, the amount could only be deducted in the subsequent period when it is due to be paid.

In respect of money borrowed by a Malaysian company from a non-resident lender, the next obstacle is Section 39(1)(f). The provision under Section 39(1)(f) specifically disallows interest expenses where the payer fails to comply the withholding tax under Section 109 of the ITA.

Where the lender party and the borrower party are "associated person" within the meaning of Section 140A, the question of deductibility also involves whether the borrower's borrowings (or financial assistance received) is excessive in relation to the fixed capital of such person. A company having a very small share capital but heavily financed by its associated person is known as "thinly capitalized". There are lucrative tax benefits of a thinly capitalized company from both the lender's and borrower's perspectives. The borrower could obtain tax deduction on the interest paid to the lender.

On the other hand, the lender will account for the corporate tax on the interest income in the tax jurisdiction it has domiciled. Often, the tax jurisdiction the lender is operating in has favourable tax regime on interest income. To counter this tax structure, many countries resorted to imposing a set of rules known as "Thin Capitalisation Rule" to discourage thinly capitalized companies by disallowing deduction on the interest expenses if the company's borrowing as at the end of the tax year exceeded its share capital by a pre-determined ratio where most countries adopted the ratio of 3:1 (debt:equity).

The thin capitalization rule in Malaysia was being introduced on 1 January 2009 but it was never being implemented immediately.

One of the reasons for the delay is the complication involved in the implementation and therefore the Government granted extension of time for the stakeholders, namely the multinational corporations ("MNC") to adjust their debt to equity ratio. The latest extension of time granted by the Government was 31 December 2017.

Just when the deadline is about to expire, the Government has made announcement in the 2018 Budget to delete the Thin Capitalisation Rules stipulated in Section 140A(4) to make way for a different set of law that is aimed to achieve the same goal of restricting interest expenses from excessive loan financing between associated person. This set of new law is known as Earning Stripping Rules or ESR. In spite of the announcement, the law relating to ESR is not introduced in the Finance Bill (No. 2) 2017. It is reckoned that the ESR will largely follow the proposals in the OECD/G20 Base Erosion and Profit Shifting ("BEPS") Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments. Action 4 is issued to address the base erosion and profit shifting issues using interest.

An overview of the ESR in Action 4 is summarized below:

Meaning of ESR and its mechanism

Similar to Thin Capitalisation Rules, ESR are recommended to control excessive deduction on interest expenses between associated persons. As discussed in Action 4, the mechanism involved in ESR in disallowing interest payments to related parties is based on the profitability of the borrowing party. It is suggested that the fixed ratio rule be adopted where a rate allowed is within the range of 10% to 30% of the Earnings Before Interest and Tax ("EBIT") or Earnings Before Interest, Tax, Depreciation and Amortisation ("EBITDA"). As stated in Action 4, *"the* premise underlying the fixed ratio rule is that an entity should be able to deduct interest expense up to a specified proportion of EBITDA, ensuring that a portion of an *entity's* profit remains subject to tax in a country.*"* A fixed ratio rule provides a country with a level of protection against BEPS. The ESR may apply to multinational or domestic group of companies.

As compared to the thin capitalization rules, a fixed ratio rule has the advantage as it is relatively simple and straight forward to apply. The disadvantage is that the fixed ratio rule does not take into account the groups operating in different industries or sectors, that may require different amounts of leverage.

The 3 steps approach of applying the fixed ratio rule is summarized as follows:

Step 1: Calculate the EBITDA, based on the tax rules of the country.

Step 2: Applying the statutory fixed ratio to the EBITDA to determine the maximum deductible interest expense.

Step 3: Comparing this with the actual interest expense.

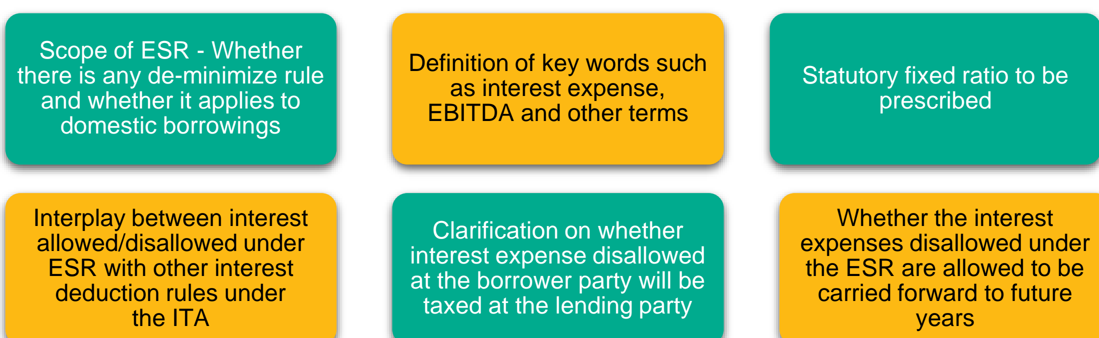
A practical example to illustrate the application of ESR is given on the next page.

ABC Sdn Bhd incurred interest expenses of RM1,200 on loan provided by its associated person. The company recorded EBITDA of RM3,000 in the same year. Assuming the maximum deduction prescribed under the law is 10% of the EBITDA, the ESR calculations are as follows:

Item	Remark	RM
EBITDA (based on tax method)	EBITDA is calculated by adding back to its taxable income the tax value for: - Net interest expense - Depreciation and amortization Tax exempt income should be excluded from EBITDA figure.	3,000
Net interest expenditure to associated parties	Interest refers to: - the cost of borrowing money and all forms of debts, - other financial payments that are economically equivalent to interest (e.g. share of profits, discounts, foreign exchange differences), - expenses incurred in connection with the raising of finance (e.g. guarantee fee).	1,200
Maximum net interest deduction allowable (10% of EBITDA)		300
Net interest disallowed		900

Grey areas

The absence of domestic rules and the detailed guidance on the implementation of ESR at this juncture has caused concerns among the tax community as well as the business community. It is almost certain that the Government will introduce ESR in Malaysia on 1 January 2019. However, the uncertainties surrounding this certainty need to be addressed as soon as possible. Some of the issues are briefly highlighted below:



What to do?

The Government has indicated that the ESR shall be implemented effective from 1 January 2019. Companies with intra-group financing will definitely be affected by ESR. Pending the release of the new rules, the immediate step is to assess the tax risks involved, followed by taking proactive measures to manage the tax risks aimed to reduce the impact of ESR on your companies.

If you need our assistance, please contact us to discuss further on the matter.

Crowe Horwath™

Contact Us

Crowe Horwath KL Tax Sdn. Bhd.
C15-5, Level 15 Tower C,
Megan Avenue II,
12 Jalan Yap Kwan Seng,
50450 Kuala Lumpur

Foo Meng Huei
Executive Director
menghuei.foo@crowehorwath.com.my
Tel : +603 2788 9898 ext: 2501

Selvi Permal
Associate Director
selvi@crowehorwath.com.my
Tel : +603 2788 9898 ext: 2584

Song Sylvia
Associate Director
sylvia.song@crowehorwath.com.my
Tel : +603 2788 9898 ext: 2514

About Us

Crowe Horwath AF 1018 is the 5th largest accounting firm in Malaysia and a member of Crowe Horwath International which is a top 10 global accounting network. The firm in Malaysia is represented in 12 locations, employs over 1,000 staff, serves mid-to-large companies that are privately-owned, publicly-listed and multinational entities, and is registered with the Audit Oversight Board in Malaysia and the Public Company Accounting Oversight Board in the US. Crowe Horwath International has 216 member firms and business associates covering 764 offices in 129 countries around the world.

Crowe Horwath taps on its global resources and strategic competencies in audit, tax and advisory to become the leading firm of choice for fast growing businesses looking for high quality, a market-driven approach and personalised service. We help clients make smart business decisions today that create lasting value for tomorrow.

Kuala Lumpur · Klang · Penang · Johor Bahru · Melaka · Muar · Kuching · Sibu · Bintulu ·Miri · Kota Kinabalu · Labuan

www.crowehorwath.com.my

Crowe Horwath AF 1018 is a member of Crowe Horwath International, a Swiss verein. Each member firm of Crowe Horwath is a separate and independent legal entity. Crowe Horwath AF 1018 and its affiliates are not responsible or liable for any acts or omissions of Crowe Horwath or any other member of Crowe Horwath and specifically disclaim any and all responsibility or liability for acts or omissions of Crowe Horwath or any other Crowe Horwath member.
© 2017 Crowe Horwath AF 1018