

# Tax Alert

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# Earning Stripping Rules (“ESR”)

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Following the 2018 Budget announcement and pursuant to Section 140C of the Income Tax Act 1967 [“the Act”], the Income Tax (Restriction on Deductibility of Interest) Rules 2019 has recently been gazetted to restrict the deduction of interest expense in connection with or on any financial assistance in a controlled transaction, also known as “ESR”. Salient points of the abovementioned Rules include:-

## Application and Effective Date

- These Rules shall 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 five hundred thousand ringgit (RM500,000) in the basis period for a year of assessment;
- For the basis period beginning on or after 1 July 2019 and subsequent basis periods.

Example:

Basis period	Section 140C
01.01.2019 to 31.12.2019	Not applicable
01.04.2019 to 31.03.2020	Not applicable
01.07.2019 to 30.06.2020	Applicable
01.10.2019 to 30.09.2020	Applicable

## Non-application

- These Rules shall not apply to:
  - a) an individual;
  - b) a licensed bank, licensed investment bank, licensed insurer and professional reinsurer;
  - c) a licensed Islamic bank, licensed takaful operator and professional retakaful operator;
  - d) a Labuan bank and Labuan investment bank;
  - e) a Labuan Islamic bank and Labuan Islamic investment bank;
  - f) a Labuan insurer and reinsurer including a Labuan captive insurance business;
  - g) a Labuan takaful operator and retakaful operator including a Labuan captive takaful business;
  - h) a development financial institution;
  - i) a construction contractor as defined under the Income Tax (Construction Contracts) Regulations 2007;
  - j) a property developer as defined under the Income Tax (Property Developer) Regulations 2007;
  - k) a person exempted under Section 127(3)(b) or Section 127(3A) of the Act in respect of the adjusted income of the person.

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## Maximum amount of interest

- The maximum amount of deductible interest expense shall be an amount equal to twenty per cent (20%) of the amount of tax-EBITDA [“earnings before interest, taxes, depreciation and amortization”] of that person from each of his source consisting of a business for the basis period for a year of assessment.

## Tax-EBITDA

- Tax-EBITDA shall be determined by the following formula:

$$\mathbf{A + B + C}$$

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A	is the amount of the adjusted income of the person from his sources consisting of a business for the basis period for a year of assessment before any restriction on deductibility of interest under Section 140C of the Act is made;
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B	is the total amount of “qualifying deductions” allowed in ascertaining the amount of the adjusted income in A;
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C	is the total amount of the “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
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- Qualifying deduction means:
  - a) Double deduction under the Act;
  - b) Deduction under any rules made under Section 154(1)(b) of the Act.
- Section 140C of the Act define:

“control”	meaning assigned to it in Section 140(5A)
“controlled transaction”	as a financial assistance: (a) between persons one of whom has control over the other; or (b) between persons both of whom are controlled by some other person
“financial assistance”	includes loan, interest bearing trade credit, advances, debt or the provision of any security or guarantee;
“interest expense”	means: (a) interest on all forms of debt; or (b) payments economically equivalent to interest (excluding expenses incurred in connection with the raising of finance).”

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## Carry forward of interest expense

- In the case of a company, where the company has interest expense which is in excess of twenty per cent of tax-EBITDA;
- The amount of that excess shall be allowed to be carried forward and deducted against the adjusted income for subsequent years of assessment subject to the maximum of twenty per cent (20%) of tax-EBITDA of the relevant year notwithstanding that the company has no interest expense in the subsequent year of assessment, until the whole amount of that excess has been fully utilized;
- The excess of the maximum amount of interest carried forward from any particular year of assessment preceding that year shall be allowed to be carried forward if the Director General is satisfied that the shareholders of that company on the first day and the last day of the basis period for the year of assessment following the year in which such amount was ascertained were substantially the same.



### Our comments

- These Rules seem to indicate that ESR under S140C shall be applicable on both domestic and cross border financial assistance on controlled transactions. It shall be noted that the original intention on the introduction of ESR is to be applicable only on cross border financial assistance on controlled transactions. We were made to understand that IRBM will be issuing a detailed ESR guidelines in due course to provide further clarification on the matter.
- If the financial assistance obtained was not used wholly for the purpose of a business, the interest expense to be disallowed under Section 140C of the Act shall be determined after the computation of interest restriction under Section 33(2) of the Act.

[Link to ESR Statutory Rules](#)

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# Contact us

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Should you have questions about this Tax Alert, please do not hesitate to contact our Tax Team in our respective offices.

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