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Tax Espresso – Special Alert
Guidelines for Restriction on Deductibility of Interest under Section 140C

Introduction

Further to the release of Income Tax (Restriction on Deductibility of Interest) Rules 2019 [the ESR Rules] (as reported in our Special Alert @ 2 July 2019), the Inland Revenue Board of Malaysia (IRBM) has on 5 July 2019, issued the Restriction on Deductibility of Interest Guidelines (ESR Guidelines) to explain the determination of the amount deductible and restricted in relation to:

(i) business interest expenses; and

(ii) other payments which are economically equivalent to interest.

Key highlights of the ESR Rules and ESR Guidelines

	ESR Rules	**ESR Guidelines**
Application	• In respect of basis period beginning on or after 1 July 2019 • Apply to a person who has been granted any financial assistance in a controlled transaction	• Same as the ESR Rules except that it is clarified in the ESR Guidelines that the ESR Rules apply to a person having interest expenses from financial assistance which is deducted in ascertaining the adjusted income before any restriction on the deductibility of interest is made under Section 140C of the Income Tax Act 1967 (ITA) of the person from each of the business source which is paid or payable to: (a) its associated person outside Malaysia; (b) its associated person outside Malaysia which operates through a permanent establishment in Malaysia; (c) 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).
Non-application	i) an individual; ii) the specified banks, insurers, reinsurers, takaful and retakaful operators, development financial institutions; iii) a construction contractor as defined under the Income	• Same as the ESR Rules except that the ESR Guidelines: ➢ did not include a person enjoying special tax holiday granted under Paragraph 127(3)(b) or Subsection 127(3A) of the ITA; and

	Tax (Construction Contracts) Regulations 2007; iv) a property developer as defined under the Income Tax (Property Developer) Regulations 2007; and v) a person who has been granted an exemption under Paragraph 127(3)(b) or Subsection 127(3A) of the ITA in respect of the person's adjusted income.	➢ added a new non-application [i.e. a special purpose vehicle (SPV) as defined under Subsection 60I(1) of the ITA]. • The ESR Guidelines has further clarified that where a construction contractor or a property developer has other business income that are not specified under the Income Tax Regulations, that business income will be subjected to Section 140C of the ITA and the ESR Rules
De minimis threshold	• The total amount of any interest expense for all such financial assistance > RM500K in the basis period for a year of assessment (YA)	• Same as the ESR Rules except that the ESR Guidelines provide that in instances where a person has multiple business sources, the threshold of RM500,000 should be accumulated from all business sources while the calculation of interest restriction should be made separately on each of the business source
Interest expense	• "Interest expense" means: (a) interest on all forms of debt; or (b) payments economically equivalent to interest. • "Interest expense" excludes expenses incurred in connection with the raising of finance	• Same as the ESR Rules except it is clarified in the ESR Guidelines that interest expense includes any interest which is not a part of expenses in determining the business profit or loss of that person. [*Example: utilisation of provision of interest account*] • Same as the ESR Rules except that the ESR Guidelines have further clarified that any interest expense incurred which is not allowable in ascertaining the adjusted income under the ITA before any restriction on the deductibility of interest is made under Section 140C of the ITA of a person from the

		business source is excluded from "interest expense" • The term "Payment economically equivalent to interest" is also defined in the ESR Guidelines and it includes: (a) profit or loss sharing concept used in Islamic financing [Section 2(7) of the ITA]; and (b) any discount or premium (capital gain/loss) on issuing or subscribing debt instruments that will be amortised through the interest expenses. In deciding whether a payment is economically equivalent to interest, the focus should be on its economic substance rather than its legal form.
Maximum amount of interest	• Twenty percent (20%) of the Tax-EBITDA of that person consisting of a business source for the basis period for a YA	• Same as the ESR Rules
Calculation of Tax-EBITDA [i.e. A+B+C formula] from each sources of business	• Tax-EBITDA = A + B + C A is the adjusted income of the person from his business sources before any restriction on deductibility of interest under Section 140C of the ITA is made; B is the total qualifying deductions allowed in ascertaining the adjusted income in A; C is the total interest expense incurred in relation to the person's gross income for any financial assistance in a controlled transaction	• Same as the ESR Rules

	from his business sources • Qualifying deduction is defined as: ○ The amount of expenditure incurred by the person computed in any deduction falling to be made under the ITA where the amount of deduction is twice the amount of expenditure by the person; and ○ any claim for deduction under any rules made under Paragraph 154(1)(b) of the ITA [e.g. secretarial and tax filing fees deduction rules, etc.] where the deduction is allowed for purposes of ascertaining the person's adjusted income.	• Same as the ESR Rules except that the ESR Guidelines further clarified that Qualifying deduction may include special deduction or claims, in ascertaining the adjusted business income as listed in IRBM's Company Return Form & Guidebook • Negative Tax-EBITDA will be considered as NIL for the calculation under the ESR Guidelines
Financial assistance	• "Financial assistance" refers to any type of monetary help or aid that a person received. For example: (a) loan; (b) interest-bearing trade credit; (c) advance; (d) debt; (e) the provision of any security; or (f) the provision of any guarantee.	• Same as the ESR Rules
Definition of "controlled transaction"	• "Controlled transaction" shall be construed 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.	• Same as the ESR Rules

		• There are scenarios in the ESR Guidelines that explain where a controlled transaction will apply under Section 140A(5A)

In closing

Given the above, Malaysian corporate groups with solely domestic borrowings would have some breathing space for now. Borrowers who are carrying out property development, construction, banking, insurance, etc and individuals are excluded. Clarification will be required on the non-inclusion of a person enjoying special tax holiday in the guide whilst the rules do include. Policies may change and hence, being vigilant will be key. Malaysian subsidiaries or branches of foreign-based MNEs with related party foreign financing will be affected. For Malaysian-based MNEs, ESR could also apply if the Malaysian subsidiaries pay interest to related parties outside Malaysia. Non-Malaysian bank financing would also be affected if it is guaranteed by a person within the group regardless of the guarantor's tax residency. Domestic financing may work better coupled with the withholding tax saving.

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