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Insights Into Earning Stripping Rules

Malaysia's commitment to fulfil the OECD's Base Erosion and Profit Sharing (**BEPS**) Action 4-Limitations on Interest Deduction is reflected through the introduction of Section 140C in the Income Tax Act 1967 (**ITA**). This is in line with the announcement that Malaysia will adopt the OECD's Earning Stripping Rules (**ESR**) effective 1.1.2019.

Under the ESR, it has been suggested that interest deduction on loans between related companies within the same group be limited to a ratio of between 10% and 30% of the companies' earnings.

Action 4: Limitations On Interest Deduction

Among the 15 Action Plans introduced by the OECD to address tax avoidance, Action 4 outlines a common approach based on best practices for preventing base erosion through the use of interest expense, for example, through the use of related-party and third-party debt to achieve excessive interest deductions or to finance the production of exempt or deferred income. The report titled "Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4 — 2016 Update" (**Report**) attempted to provide measures to counter base erosion and profit shifting through interest deductions and other financial payments.

It is alleged that in the absence of any law or regulation limiting the level of debt financing, most companies generally will opt for debt financing as against equity financing, especially multinational corporations (**MNCs**) that can take advantage of intergroup financing of operations in multiple jurisdiction with non-aligned tax provisions with respect to taxation of debt and equity.

The OECD BEPS Action 4 aims to combat the use of excessive debt financing and other hybrid instruments by MNCs and other hybrid entities to take advantage of interest deductions to lower their taxable profits.

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De minimis Monetary Threshold

A *de minimis* threshold is imposed to exclude low-risk entities from the scope of the fixed ratio rule and group ratio rule. It is recommended that such a threshold be based on the total net interest expense of all entities in the local group. Excluding these entities from the fixed ratio rule and group ratio rule would mean that a best practice approach can focus on entities that pose material base erosion and profit shifting risk, reducing compliance costs for other entities.

Fixed Ratio Rule

This allows an entity to deduct net interest expense up to a benchmark net interest/EBITDA ratio where relevant factors help a country set its benchmark ratio within a corridor of 10%-30%.

Group Ratio Rule

A group ratio rule may be introduced as a separate additional provision, or as an integral part of an overall rule including a fixed ratio rule. This allows an entity to deduct net interest expense up to its group's net interest/EBITDA ratio, where this is higher than the benchmark fixed ratio. There is an option for a country to apply an uplift to a group's net third party interest expense of up to 10%.

Carry Forward Of Disallowed Interest, etc

Permitting disallowed interest expense and unused interest capacity to be used in other periods through carry forward or carry back provisions would have clear benefits for entities, reducing the risk of a permanent disallowance of interest expense where interest expense and EBITDA arise in different periods. This could also support a policy that the level of an entity's net interest deductions should be linked to its level of earnings over time.

General Interest Limitation Rules

Targeted interest limitation rules include any provisions that apply to restrict interest deductions on payments made under specific transactions or arrangements. These may be compared with general interest limitation rules, such as the fixed ratio rule

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and group ratio rule, which impose an overall limit on an entity's interest deductions. However, targeted rules can also provide an effective solution to some base erosion and profit shifting risk.

Banking & Insurance Sectors

As a fixed ratio rule and group ratio rule in the Report are unlikely to address base erosion and profit shifting in the banking and insurance sectors, countries may consider excluding entities in groups operating in these sectors from the scope of these rules, in which case they should introduce targeted rules addressing base erosion and profit shifting in these sectors.

Section 140C

This provision essentially states that no deduction shall be allowed in respect of any interest expense in connection with or on any financial assistance in a controlled transaction granted directly or indirectly to that person which is in excess of the maximum amount of interest as determined under any rules made under the ITA. The key definitions under Section 140C are as follows:

• Control	The same expanded definition of control as prescribed in Section 140A(5A) will be applicable
• Controlled transaction	Financial assistance between persons one of whom has control over the other, or both are controlled by a third person
• Financial assistance	Includes loan, interest-bearing trade credit, advances, debt or the provision of any security or guarantee
• Interest expense	Interest on all forms of debts or payments economically equivalent to interest (excluding expenses incurred in connection with the raising of finance)

Section 140C will apply without prejudice to Section 140 or 140A and subject to any further rules to be gazetted. The final rules with regard to deductibility of interest payment have yet to be issued.

Conclusion

The maximum amount of interest expense relating to financial assistance in a controlled transaction that can be deducted under Section 140C is yet to be confirmed as to date, there are no rules made under the ITA. However, as the implication of Section 140C is far-reaching, MNCs and companies that give or receive financial assistance to or from ~~its~~ related companies should look into their related party transactions pertaining to financial assistance and be prepared for the implementation of ESR.

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