

### Tax Newsletter - BEPS Series

Kuala Lumpur

## Newsletter

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## Malaysia – BEPS Newsletter Series 2

#### What is BEPS?

Base Erosion & Profit Shifting ("**BEPS**") refers to tax planning strategies taken by multinational enterprises to exploit gaps and mismatches in tax rules worldwide, reducing tax payable by shifting their profits to jurisdictions with lower tax rates.

The BEPS project was initiated by the OECD and G20 countries in 2013. In October 2015, a comprehensive 15-point Action Plan was released in response to growing concerns about the inability of the international tax system to keep up with globalisation. The BEPS package sets out 15 actions along the key pillars of (i) improving coherence of corporate income taxation to reduce loopholes in the interaction of countries' domestic tax laws, (ii) establishing substance requirements in international standards, and (iii) ensuring a transparent tax environment as well as certainty. It is expected that once implemented, measures recommended under the BEPS package will result in the taxation of profits where the economic activities that generate them take place and where value is created.

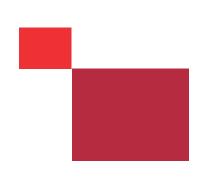
The OECD established the Inclusive Framework ("**IF**") in January 2016 so that countries and jurisdictions can collaborate on the implementation of the BEPS package. At the IF meeting on 25 – 27 January 2017 in Paris, Malaysia announced its intention to join the IF. In March 2017, the OECD welcomed Malaysia officially as a BEPS Associate. As such, Malaysia now has a voice in the development of standard setting and BEPS implementation monitoring.

# BEPS Action 4 – Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

#### Overview

In October 2015, the OECD issued its initial report on Limiting Base Erosion Involving Interest Deductions and Other Financial Payments. The initial report was subsequently updated with additional guidance in December 2016 ("Final Report").

Action 4 focuses on the use of third party and intra-group debt to achieve excessive interest deductions or to finance the production of exempt or deferred income. In the Final Report, it was observed that base erosion and profit shifting could potentially arise from the following arrangements:





Placement of higher levels of third party debts in high tax countries Ues of intragroup loans to generate interest deductions in excess of the group's actual third party interest expense Use of third party or intragroup financing to fund the generation of tax exempt income

To address these risks, the Final Report analysed several best practices and recommended an approach that would directly address the identified risks. The recommended approach centers around the fixed ratio rule, which seeks to limit an entity's deduction for interest (or other economically equivalent) expenses to a percentage of its income before interest, taxes, depreciation and amortisation ("EBITDA").

## Recommendations in the Final Report

The key features of the recommendation in the Final Report include:

#### **Fixed Ratio Rule**

An entity is allowed to deduct net interest expense only to a benchmark net interest to EBITDA ratio of between 10% - 30%

Rationale: Ensures that an entity's interest deduction is directly linked to its economic activity



#### **De Minimis Threshold**

Optional monetary threshold based on the total net interest expense of all entities in the local group.

**Rationale:** To remove low risk entities - entities falling below the threshold are not subject to the fixed ratio rule



#### **Group Ratio Rule**

Optional rule - entity is allowed to deduct net interest expense up to its group's net interest to EBITDA ratio, (where this is higher than the benchmark fixed ratio)

**Rationale:** To allow certain groups which are more highly leveraged due to their nature of the business, to have a higher ratio



## Carry forward or back of disallowed interest and unused interest capacity

Optional rules to allow carry forward and/or carry back of any disallowed interest and unused interest capacity

Rationale: To address issues in the event that an entity's interest expense and earnings arise in different periods



#### **Targeted Rule**

Additional targeted rules to address specific risks

**Rationale:** Further rules to deal with specific base erosion and profit shifting risks.



#### Specific rules for the banking and insurance sectors

Different set of rules will apply to entities in the banking and insurance sectors

Rationale: Separate rules should be developed for insurance and banking companies, given the particular features of these industries

## Malaysia – Response and Implementation

It is not mandatory for Malaysia to implement the recommendations in the BEPS Action 4 Final Report as a BEPS Associate. However, in the 2018 Budget speech released in October 2017, the Malaysian Prime Minister announced that earning stripping rules ("**ESR**"), similar to those proposed under the Final Report, will be introduced.

It was previously proposed that thin capitalisation rules would be enforced in Malaysia from 1 January 2018 onwards. The thin capitalisation rules were intended to stipulate conditions under which deductions for interest charges would be disallowed, based on the debt to equity ratio of the entity. The thin capitalisation rules have now been repealed, and will be replaced with the proposed ESR regime.

Under the ESR, it is proposed that the interest deduction on loans between related companies within the same group will be limited to a ratio to be determined by the Malaysian Inland Revenue Board ("MIRB"), ranging between 10% - 30% of the company's profit before tax.



At current time, the MIRB has yet to publish the draft guidelines or regulations relating to the ESR. Some of the key considerations that should be addressed in the formulation of the ESR regime include the following:

Denominator for the fixed ratio- EBIT or EBITDA

Interaction of ESR with existing interest deduction rules

Introduction of group ratio rules

Transitional rules for existing financial arrangements

The ESR rules are proposed to be effective from 1 January 2019, and it is expected that more detailed rules and guidelines relating to the ESR will be released by the MIRB in due course. Given that the ESR rules will have far-reaching implications on the financing arrangements for businesses, it is also hoped that the MIRB will consider carrying out a formal consultation process on the draft ESR regulations to obtain feedback from businesses, professional bodies as well as trade associations in developing the ESR rules.

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