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Section 140C of the Income Tax Act 1967 and the Income Tax (Restriction on Deductibility of Interest) Rules 2019

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By the Tax and Revenue Practice Group

Finance Act 2018 had introduced a new **Section 140C** to the **Income Tax Act 1967** ("ITA") to restrict the deductibility of interest expenses incurred by a person in respect of his business income in certain circumstances.

Pursuant to Section 140C, where such interest expenses are in connection with or on any financial assistance in a controlled transaction granted directly or indirectly to that person and are in excess of the maximum amount of interest as determined by any rules made under the ITA, the interest expenses are restricted.

The definitions of "*controlled transactions*", "*financial assistance*" and "*interest expense*" are provided in **Section 140C(3)** of the ITA.

Although Section 140C of the ITA took effect from 1 January 2019, its implementation however requires certain rules to be prescribed by the Minister of Finance and in this regard, the **Income Tax (Restriction on Deductibility of Interest) Rules 2019 [P.U.(A) 175/2019]** ("the Rules"), which were gazetted on 28 June 2019, finally came into operation on 1 July 2019.

- **Application**

The Rules apply to:

(a) a person who has been granted any financial assistance in a controlled transaction whereby the total amount of interest expense for all such financial assistance exceeds RM500,000 in the basis period for a year of assessment ("Y/A"); and

(b) the basis period beginning on or after 1 July 2019 and subsequent basis periods.

- **Non-application**

The Rules do not apply to:

(a) an individual;

(b) certain banks, insurers, reinsurers, *takaful* and re*takaful* operators;

(c) a development financial institution which is prescribed under the **Development Financial Institutions Act 2002**;

(d) a construction contractor as defined under the Income Tax (Construction Contracts) Regulations 2007;

(e) a property developer as defined under the Income Tax (Property Developer) Regulations 2007; and

(f) a person who has been granted an exemption under Sections 127(3)(b) or 127(3A) of the ITA in respect of the adjusted income of the person.

For further information regarding tax and revenue law, please contact:

Goh Ka Im
kgoh@shearndelamore.com

Anand Raj
anand@shearndelamore.com

Irene Yong
irene.yong@shearndelamore.com

7th Floor
Wisma Hamzah – Kwong Hing
No.1, Leboh Ampang
50100 Kuala Lumpur, Malaysia
T: +603 2027 2727
F: +603 2078 5625
E: info@shearndelamore.com
W: www.shearndelamore.com

- **Maximum amount of interest**

It is stipulated in the Rules that the phrase "*maximum amount of interest*" referred to in Section 140C shall be an amount equal to 20% of the amount of tax-EBITDA of that person from each of his business sources for the basis period for a Y/A.

- **Tax-EBITDA** (**E**arnings **B**efore **I**nterest, **T**axes, **D**epreciation and **A**mortisation)

The amount of tax-EBITDA in turn is ascertained using the formula of $\boxed{A + B + C}$ where:

A is the amount of the adjusted income of the person from his business sources for the basis period for a Y/A before any restriction on deductibility of interest under Section 140C is made

B is the total amount of qualifying deduction (as defined in the Rules) allowed in ascertaining the amount of the adjusted income in **A**

C is the total amount of interest expense incurred in relation to the gross income of the person for any financial assistance in a controlled transaction from his business sources for the basis period for a Y/A

- **Carry forward of interest expense**

In the case of a company, the Rules allow a company to carry forward interest expenses which are in excess of the maximum amount of interest and deduct the same against the company's adjusted income for subsequent Y/As subject to the maximum amount of interest for the relevant year notwithstanding that the company has no interest expense for any subsequent Y/A, until the whole amount of that excess has been fully utilized, provided that the Director General of Inland Revenue is satisfied that shareholders of the company on the first day and last day of the basis period for the subsequent Y/A were substantially the same.

In this connection, the Rules provide that the shareholders of the company at any date shall be substantially the same as the shareholders at any other date if on both those dates:

(i) more than 50% of the paid-up capital in respect of the ordinary share (as defined in the Rules) of the company is held by or on behalf of the same persons; and

(ii) more than 50% of the value of the allotted shares in respect of ordinary share in the company is held by or on behalf of the same persons.

- **Revenue's Guideline**

The Inland Revenue Board has also issued the "Restriction on Deductibility of Interest Guidelines [Section 140C, Income Tax Act 1967]" on 5 July 2019.

Foong Pui Chi from our Tax and Revenue Practice Group contributed this article.

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Goh Ka Im
kgoh@shearndelamore.com

Anand Raj
anand@shearndelamore.com

Irene Yong
irene.yong@shearndelamore.com

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