

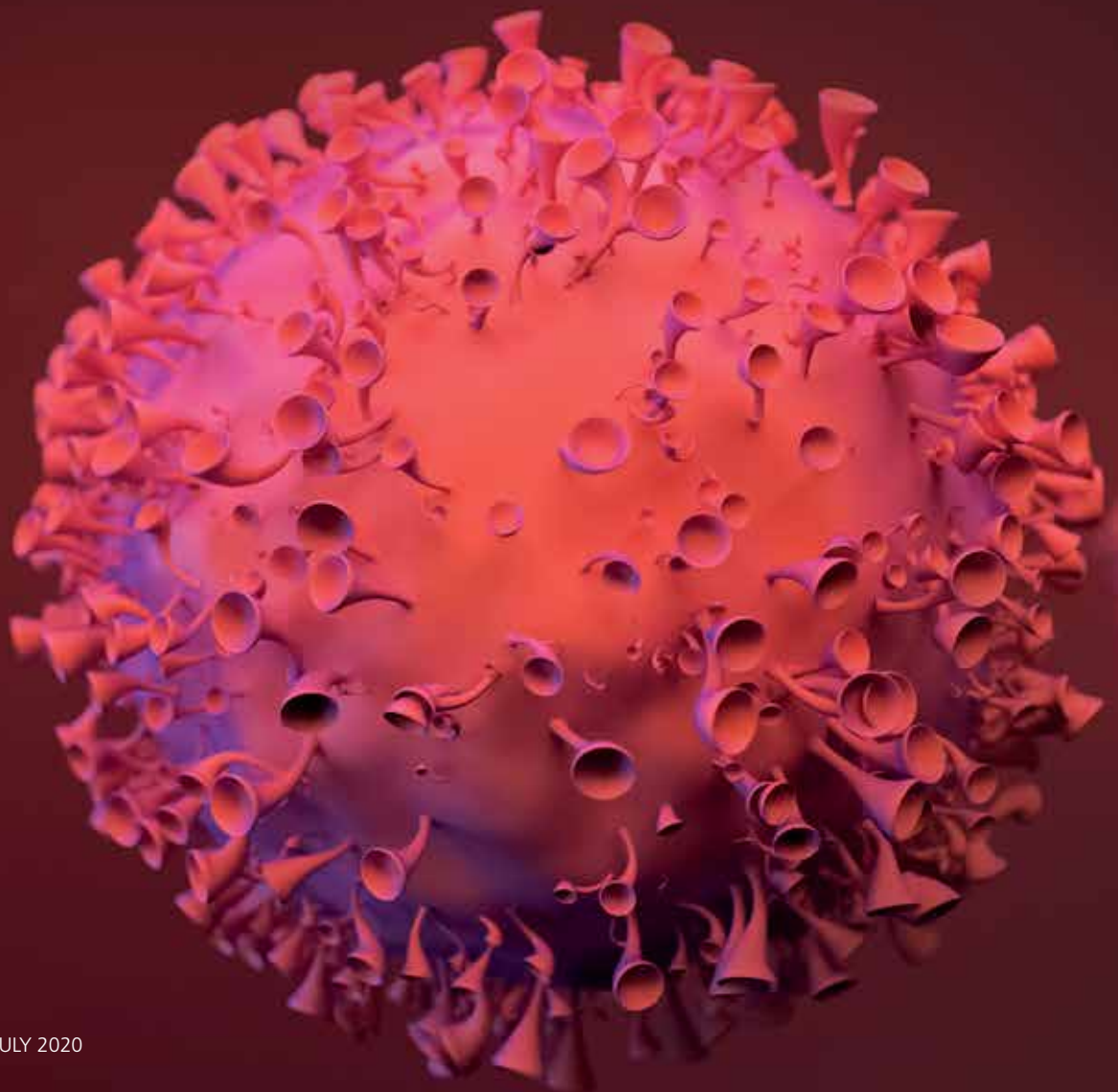
# COVID-19 TAX IMPLICATIONS ON BUSINESS RESTRUCTURING

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"THE WORLD HEALTH ORGANISATION (WHO) HAS BEEN ASSESSING THIS OUTBREAK AROUND THE CLOCK AND WE ARE DEEPLY CONCERNED BOTH BY THE ALARMING LEVELS OF SPREAD AND SEVERITY AND BY THE ALARMING LEVELS OF INACTION. WE HAVE THEREFORE MADE THE ASSESSMENT THAT COVID-19 CAN BE CHARACTERISED AS A PANDEMIC."



WHO issued the above statement on 11 March 2020, which officially characterised the COVID-19 outbreak as a pandemic. Following this, many countries around the world went into lockdowns with the hope of curbing the spread of the virus. The lockdowns followed by social distancing have increased the risk of companies going into insolvency, no matter how established they are. Companies are struggling to keep their financial wheels turning, which has created unprecedented business liquidity issues.

The *Financial Times* reported on 25 May 2020 that the “V, U, W, L: are just some of the letter-shaped recoveries that investors have put forward as paths for the US economy once the worst of the crisis is over. The idea of a Nike swoosh recovery has taken hold, implying a rebound in economic activity that is flatter and slower than the drop. The most optimistic forecast – the V-shaped rebound – has been dismissed suggesting a much less robust resurgence after what may well be the worst downturn since the Great Depression.”

Given the many tax issues which the pandemic has created, for this article, we will only focus on the tax implications arising from business restructuring.

To weather the impact of the COVID-19 situation, many companies are looking into restructuring and reorganising their businesses.

What businesses should know if they intend to restructure? Are there any tax implications on the methods used to restructure or reorganise their businesses?

## INTRODUCTION

A company undertakes a restructuring exercise to modify the financial and operational aspects



of the company significantly. This happens when the business is facing financial pressures. Restructuring involves considerably modifying the debt, operations or structure of a company as a way of limiting financial harm and improving the business.<sup>1</sup>

Briefly, business restructuring can happen in the following manner:

- (i) *Operational restructuring*  
Operational restructuring is a corporate action taken to significantly modify the structure or the operations of the company, which usually happens when a company is facing significant problems and is in financial jeopardy.<sup>2</sup>
- (ii) *Debt restructuring*  
Debt restructuring is a process wherein a company or an entity experiencing financial distress and liquidity problems refinances its existing debt obligations to gain more flexibility in the short - term and make their debt load more manageable overall.<sup>3</sup>

## OPERATIONAL RESTRUCTURING – HOW DOES IT WORK?

Operational restructuring comes in handy when a company is faced with an “out of cash” situation. The relevant

company does not have a positive cash flow from its operations because of disruption in its income stream. Globally or locally, the COVID-19 pandemic has forced many companies to experience this kind of situation. So, what are the options available to these companies? In the worst case scenario, a company may be forced to shut down to avoid being in a continuous loss-making situation. In the case of a group of companies, merging businesses could be a step to reduce the operating cost of the group. Selling of assets and properties may also be on the cards to generate cash flow.

Let us look at some of the ways operational restructuring can be done and explore the tax implications of each method:

- (i) *Consolidation / Merging of businesses*  
Consolidating or merging of businesses could be an option for groups of companies to mitigate the overall operating

<sup>1</sup> <https://www.who.int/dg/speeches/detail/who-director-general-s-opening-remarks-at-the-media-briefing-on-covid-19---11-march-2020>

<sup>2</sup> <https://efinancemanagement.com/corporate-restructuring>

<sup>3</sup> <https://corporatefinanceinstitute.com/resources/knowledge/finance/debt-restructuring/>

cost. This can be done by transferring assets, undertaking liabilities as well as moving employees from one company into another company. Even though the size of the group will shrink, it will help even out the overall overhead costs. Are there any tax implications on this? Generally, any gain arising from this restructuring exercise will not attract any income tax in the Malaysian tax perspective as this is deemed a capital gain. Conversely, any expenses incurred to transfer the business would not be allowed a tax deduction as they do not satisfy Section 33(1) of the Income Tax Act 1967 as expenses which are wholly and exclusively incurred in the production of income. There should also be no Real Property Gains Tax (RPGT) implications for the transfer of business from one company to another without the transfer of any real properties or shares in a real property company (RPC). However, stamp duty at the *ad valorem* rate ranging from 1% to 4% will be applicable in respect of any instrument to enact the transfer of business.

(ii) *Flattening the group structure*  
An option is available for a group of companies to flatten its group structure. This can be done by transferring the shares of any company to be held under a single holding company. This will help in times of cash constraint caused by this COVID-19 pandemic as profitable companies within the group can declare a dividend to the holding company which in turn can flow the cash to other companies that need the cash by way of intercompany loan or direct capital injection. However, it should be noted that a company is prohibited under Section 123 of the Companies Act 2016 from giving financial assistance for acquiring shares in the company or its holding company, or for reducing or discharging a liability incurred for such an acquisition. Nevertheless, if the requirements in Section 126 of the Companies Act 2016 (“whitewash” procedures) are satisfied, a special resolution can be passed in respect of the intercompany loan. Are there any tax implications with regards

to the transfer of shares within the group? Generally, any profits gained from the sale of shares would be a capital gain and would not be subject to income tax. There should be no RPGT implications for the transfer of shares from one company to the holding company, unless it is a transfer of shares of an RPC, in which then, RPGT would be applicable at the RPGT rate for companies ranging from 10% to 30% depending on the holding period of the shares being sold. In the case of a share transfer, the instrument to enact the transfer of shares would be subject to stamp duty at the rate of 0.3% of the consideration or market value of the shares, whichever is the higher. Do note however that stamp duty and real property gains tax exemptions may be applicable if the stipulated conditions are satisfied.

(iii) *Selling of properties and assets*  
Simon Underwood, a business recovery partner at accountancy firm Menzies said that, companies should watch for “financial red flags”, including difficulty paying creditors or employees on time.<sup>4</sup> These red flags could be an indication of a cash flow problem which forces most companies to sell their properties and assets. The cash flow generated from the sales of properties and assets will be a capital gain unless the company is in the business of trading properties. However, in this case RPGT within the range of 10% - 30% (depending on the holding period of the property) will be applicable on the sale of any properties situated in Malaysia. Stamp duty at an *ad valorem* rate ranging from 1% to 4% will also be chargeable on the sale and purchase agreement or the





memorandum of transfer, as the case may be. It should also be noted that under the Companies Act 2016, the company must pass a resolution before the directors of the company can dispose of a substantial portion of the company's business which includes all tangible and intangible assets.

(iv) *Movement of employees*

Jorge Paulo Lemann, co-founder of Banco Garantia once said, "The greatest asset of a company is its people." As companies embark to reorganise their businesses, the welfare of their

lost or damaged items during the moving process will generally qualify for tax deduction if such relocation results in enhanced business efficiency. However, if the relocation arises from the transfer of business from one company to another company which results in the closing down of a company's operations, such relocation expenses may not qualify for a tax deduction. Besides the temporary relocation of employees, businesses may even need to downsize their operations. Some employers may choose to reduce costs



employees should also be looked into. Businesses will likely need to make some adjustments to their current operations as there is no indication of how long this crisis will last. As a result, businesses may choose to temporarily relocate their staff to other companies within the group for better profit and cash flow management. Relocation expenses such as fees incurred for planning and execution or supervision of the relocation process, transportation cost, and insurance premium to cover the

by way of staff retrenchment. Generally, compensation paid to employees for loss of office is tax deductible if such payment results in the company's business operations being more efficient<sup>5</sup>. However, compensation made by the successor company in respect of services rendered by an employee to the previous company in a reorganisation plan may not be tax deductible. Compensation made to an employee in lieu of notice for a period after the business has ceased will also not be tax

deductible. In view of the above, any relocation or retrenchment plan by businesses should be given due consideration in order to minimise any adverse tax implications.

(v) *Winding up*

As a last resort, companies will just choose to close their doors to avoid making further losses. What happens when a company is liquidated? All its assets will be sold to settle its debts whilst any excess of cash will be distributed to its owners or shareholders. The capital distribution paid out to the shareholders will be a capital receipt in the hands of the shareholders. The expenses incurred on services for the liquidation exercise would be capital expenditure and not be allowed a tax deduction because it would not satisfy Section 33(1) of the Income Tax Act 1967 as expenses that are wholly and exclusively incurred in the production of income.

**DEBT RESTRUCTURING - WHAT DO YOU NEED TO KNOW?**

The airline industry, cruise line companies, hoteliers, entertainment parks and small businesses which are being hit the hardest by the pandemic are faced with the unprecedented stress of servicing their debts. As with all the good things happening in the wake of this virus, like the selflessness of our frontliners, debtors may find that their lenders may be willing to work something out. There are several ways to structure a debt workout, namely, reduction of interest rates and deferral of payment period or

<sup>4</sup> <https://www.cips.org/supply-management/news/2020/march/coronavirus-how-to-spot-financial-distress-in-the-supply-chain/>

<sup>5</sup> *DGIR v Kulim Rubber Plantation Ltd (1981) 1 MLJ 214*

extension of maturity date. Certain elements of debt restructuring and the tax treatments in relation to it are further discussed below:

(i) *Bad debts written off*

What is a bad debt? A bad debt expense is recognised when a receivable is no longer collectible because a customer is unable to fulfill its obligation to pay an outstanding debt due to bankruptcy or other financial problems. Typically, it is a situation where an insolvent debtor is unable to settle debts. Further, Public Ruling 4/2019 - Tax Treatment of Wholly and Partly Irrecoverable and Debt Recoveries denotes that a debt can be considered as wholly irrecoverable or bad on the occurrence of any one of the following:

- a) The debtor has died without leaving any assets from which the debt can be recovered;
- b) The debtor is a bankrupt or under liquidation and there are no assets from which the debt can be recovered;
- c) The debt is statute-barred;
- d) The debtor cannot be traced despite various attempts and there are no known assets

from which the debt can be recovered;

- e) Attempts at negotiation or arbitration of a disputed debt have failed and the anticipated cost of litigation is prohibitive; or
- f) Any other circumstances where there is no likelihood of cost-effective recovery.

Referring to the list above, companies facing financial difficulties as a result of the COVID-19 pandemic will see their debts falling bad when the amounts are being written off in the creditor's books.

ii) *Deduction of bad debts*

What is the recourse available to the creditors in terms of tax deductions? Section 34(2) of the Income Tax Act 1967 allows a trade debt which is reasonably estimated to be irrecoverable either wholly or partly, to be deducted from gross income in computing the adjusted income of the creditor's business. So, the creditor will be able to enjoy a tax deduction if there are sufficient supporting documents to prove that the debt is bona fide and reasonable steps have been taken to recover the debts.

iii) *Waiver of intercompany loans*

Waiver of intercompany loans will occur more now with the onset of the COVID-19 pandemic. Groups of companies will attempt to restructure their financials to benefit the group as a whole. A point to note is the taxability of waiver of debts as income in the hands of the beneficiary. Section 30(4) of the Income Tax Act 1967 specifically provides for certain receipts to be treated as gross income from a business which includes the release of a debt in respect of expenditure previously allowed as a deduction. This principle is established in the case of *Ketua Pengarah Hasil Dalam Negeri v Bandar Nusajaya Development Sdn Bhd*<sup>6</sup> where only the business income portion of the waived loan is to be brought to tax.

Businesses must ensure that they are aware of all the tax treatments related to debt restructuring before embarking on waiving debts and claiming deduction on bad debts written off. Proper tax advice and consultation should be obtained so that businesses are able to prove their case when the Inland Revenue Board of Malaysia scrutinises the business decision during future tax audits or investigations.

### **MALAYSIA'S RESCUE APPROACH**

With the view of assisting companies and businesses to mitigate the impact of the COVID-19 pandemic, the Malaysian government has implemented various plans and measures. Malaysia announced the first Economic Stimulus Package valued at RM20 billion on 27 February 2020 to ease the financial burden of the people and certain categories of businesses followed by the Prihatin Economic Stimulus Package valued at RM250 billion on 27 March 2020. An Additional Prihatin SME Economic Stimulus Package valued at RM10 billion was announced on 6 April 2020 for the micro, small and medium enterprises. As Malaysia moves into the recovery





phase of the COVID-19 pandemic, the government also unveiled the Short Term Economic Recovery Plan valued at RM35 billion on 5 June 2020. Among the measures introduced by the Malaysian government are a wage subsidy programme to employers for a period of up to six (6) months to retain their employees earning a monthly income of RM4,000 and below, restructuring and rescheduling of employer's contributions for the Employees Provident Fund and suspension of income tax payments for a period of three (3) to six (6) months. In line with the Stimulus Package, the Malaysian banking sector has also stepped up measures to provide financial relief to help its customers affected by the COVID-19 pandemic by, amongst others, rescheduling or restructuring of loans, offering payment moratoriums as well as providing short-term financing to help alleviate short-term cash flow problems. Further, Bank Negara Malaysia has allocated a RM2 billion special relief facility which will be specifically deployed in the form of working capital for small and medium enterprises. Agreements entered into arising from these rescheduling, restructuring, or moratorium exercises will be given a 100% stamp duty exemption. The exemption can be used for agreements

entered into between 1 March 2020 and 31 December 2020 on condition that the original loan agreement has been duly stamped. While the suite of the above measures is a welcome balm, such measures without more, may not be sufficient. This is especially so for the small and medium enterprises who may require a more in-depth survival kit to sustain their businesses in the aftermath of this outbreak in order to avoid facing insolvency proceedings by their creditors.

Other options to rehabilitate the business and finances of distressed companies in order to avoid liquidation are also available within the provisions of the Companies Act 2016. There are officially three (3) corporate rescue mechanisms available under the Companies Act 2016, namely, corporate voluntary arrangement, judicial management and scheme of arrangement and reconstruction. Sole proprietors also have an option provided under the Insolvency Act 1967 known as a voluntary arrangement. This is an arrangement for a small business owner before he becomes insolvent, to rearrange his debts with his creditors.

<sup>6</sup> *DGIR v Bandar Nusajaya Development Sdn Bhd (2016) MSTC*

## CONCLUSION

In conclusion, this pandemic has surely affected every business. Even the larger corporations have been impacted by the lockdowns imposed as well as the social distancing practice thereafter. Business strategies should be reassessed in order to

survive the short - term and long - term impact of this pandemic. The government, financial institutions, tax authorities and all relevant parties should render their utmost support to businesses to help them out through this struggle. With cooperation from all parties, the country's economy can be revived and shaped back in a faster scale. It should be remembered that each of us are definitely not alone in combating this battle and we will surely overcome this. As the saying goes, "Every cloud has a silver lining, so is this COVID-19's cloud".



*Disclaimer: This article does not seek to address all tax issues associated with the Covid-19 pandemic.*

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