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## Tax Deduction Of Borrowing Costs

Section 33(1) of the Income Tax Act 1967 (**ITA**) is the basket provision that allows businesses to deduct most of their operating costs in the course of determining the taxable income. Outgoings and expenses that are wholly and exclusively incurred in the production of gross income — or what is known as “revenue expenses” among tax practitioners — qualify for tax deduction under this provision, subject to the limitation prescribed under Section 39(1) of the ITA.

The deductibility of borrowing costs is constantly contested by the Inland Revenue Board (**IRB**). Paragraph 6.2 of the IRB’s Public Ruling No 6/2006 (*Tax Treatment of Legal and Professional Expenses*) states that costs incurred to procure a loan are not deductible as those are regarded as capital expenses.

Despite the IRB’s stance, the Special Commissioners of Income Tax (**SCIT**) in *KM v Ketua Pengarah Hasil Dalam Negeri* held that borrowing costs in relation to raising finance are deductible expenses. Our lawyers from the firm’s Tax, SST & Customs Practice are representing the taxpayer before the High Court.

### Brief Facts

The taxpayer and its subsidiaries are in the plantation business, with plantations being their investment assets. In the course of its business, the taxpayer entered into the following financing transactions:

#### *First financing transaction*

- (a) The taxpayer obtained a bridging loan of US\$100 million to finance a share acquisition in a foreign plantation company. Due to the Asian financial crisis, the taxpayer could not fulfil its financial obligations and proceeded to obtain a separate syndicated loan for the same sum to replace the first bridging loan.

#### Contact persons:



**Datuk D. P. Naban**  
Senior Partner  
Tax, SST & Customs Practice  
T: +603 6208 5858  
E: [dpn@lh-ag.com](mailto:dpn@lh-ag.com)



**S. Saravana Kumar**  
Partner  
Tax, SST & Customs Practice  
T: +603 6208 5813  
E: [sks@lh-ag.com](mailto:sks@lh-ag.com)

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- (b) Subsequently, the taxpayer obtained an additional loan of US\$18 million through a facility agreement and US\$68 million through a syndicated loan to finance the said acquisition.
- (c) The taxpayer earned dividend income from its share investment.

### *Second Financing Transaction*

- (d) In 1994, the taxpayer obtained a bank guarantee for the issuance of RM140 million Redeemable Convertible Bank Guaranteed Bonds. One of the key conditions of the guarantee was that RM75 million of the total proceeds from the bonds must be used to construct the taxpayer's head office.
- (e) Upon completion of the construction of the head office in 1998, the floor space in the building was rented out, for which the taxpayer earned rental income.
- (f) Later, in 1999, the taxpayer entered into a facility agreement to obtain a term loan facility of RM140 million, the purpose of which was to redeem the bonds upon maturity.

### *Third Financing Transaction*

- (g) Pursuant to an Islamic financing arrangement, the taxpayer obtained funds amounting to RM267.5 million to refinance a US\$80 million loan obtained previously by its subsidiary. The US\$80 million loan was used by the subsidiary to finance its investment in a foreign oil palm plantation.
- (h) If there was default on the US\$80 million loan, it could trigger a cross default at the group level and at the taxpayer's level as the holding company.

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Level 6, Menara 1 Dutamas  
Solaris Dutamas  
No. 1, Jalan Dutamas 1  
50480 Kuala Lumpur  
Malaysia  
Tel: +603 6208 5888  
Fax: +603 6201 0122  
Email: [tax@lh-ag.com](mailto:tax@lh-ag.com)

In raising these various financing transactions, the taxpayer incurred interest expenses and other related costs, such as:

- Commitment fees
- Legal fees and disbursements
- Professional fees
- Front-end fees
- Acceptance fees
- Stamp duties
- Processing fees
- Arrangement fees
- Agency fees
- Security agent fees
- Facility agent fees
- Break-funding loss.

The Director General of Inland Revenue (**DGIR**) disallowed the deductibility of these borrowing costs and raised additional tax assessments against the taxpayer. Aggrieved by the assessments, the taxpayer filed an appeal to the SCIT.

### DGIR's Contentions

In disallowing the borrowing costs, the DGIR argued that:

- (a) Since the loans were obtained to increase capital, the borrowing costs incurred in relation to the loan were capital in nature and thus, were not a deductible expense.
- (b) The nature of the borrowing costs is a “once and for all” payment directly relating to the coming into existence of an asset in the form of capital.
- (c) The taxpayer derived most of its income from the plantation business. As it is not in the business of providing banking or financial services whereby money constitutes its stock-in-trade, the borrowing costs were not incidental to the taxpayer’s plantation business.

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## Taxpayer's Reply

Among other things, the taxpayer's argument can be summarised as follows:

- (a) The various loans procured were for its business purposes, i.e., for the general working capital of the taxpayer to finance its business operations or to finance its business acquisitions.
- (b) The interest and borrowing costs are regarded as costs of business which are necessary for the taxpayer's business.
- (c) The various borrowings obtained had resulted in the growth and expansion of the taxpayer's business and revenue.
- (d) It is normal for businesses including that of the taxpayer to obtain loans to finance business operations and to incur interest and borrowing costs in respect of the loans.
- (e) Unless there is a statutory provision to provide otherwise, there is no distinction between interest in respect of a loan and an expenditure incurred to obtain the loan.
- (f) A loan cannot be treated as an asset or advantage for the enduring benefit of the business of a taxpayer. Instead, a loan is a liability which has to be repaid. Thus, it is erroneous to consider a liability as an asset or an advantage.
- (g) The nexus linking the interest and borrowing costs was integral to the financing in that they were crucial and critical to the earning of income.

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## SCIT's Decision

Upon hearing the submissions of both parties, the SCIT ruled in favour of the taxpayer and held that the borrowing costs qualify for tax deductions under Section 33(1) of the ITA. Although the SCIT have yet to provide their written grounds, it can be concluded that the SCIT accepted the contention that the financing obtained by the taxpayer cannot be treated as assets of an enduring nature.

## Conclusion

This recent decision is encouraging as it recognises the position that borrowing costs incurred in the ordinary course of business are not capital in nature and, hence, tax deductible. It also shows that the IRB's position communicated through its Public Rulings is not law as they do not carry any legal effect. Public Rulings that are contrary to the law and established principles of tax law can be challenged before a court of law.

For queries pertaining to tax deduction of interest expenses and borrowing costs, please contact our partners **Datuk D P Naban** or **S Saravana Kumar** from the firm's Tax, SST & Customs Practice at [tax@lh-ag.com](mailto:tax@lh-ag.com)

For the preparation of corporate financing documentation, please contact our Corporate Finance partner, **Ong Eu Jin** ([oej@lh-ag.com](mailto:oej@lh-ag.com)).

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