

---

**TECHNICAL**

---

**Direct Taxation**

**TAX CASE UPDATE**

**Is interest expense incurred on funds used for the giving of interest-free loans deductible?**

**FEDERAL FURNITURE HOLDINGS SDN. BHD. v KPHDN**

High Court of Malaya at Kuala Lumpur

Civil Appeal No: R1-14-17-2009

Date of Judgment: 23 April 2010

**Facts and Issues:**

This is an appeal against the decision of the Special Commissioners of Income Tax (SCIT) in dismissing the appellant's appeal against assessments for the following years of assessment (YA) by the Director General of Inland Revenue (the Respondent):

YA	Type of assessment	Date of assessment	Amount (RM)
2002	Original	28.08.2006	31,270.40
2003	Original	28.08.2006	54,761.08

The issue for determination by the SCIT was whether the interest expenses for YA 2002 and YA 2003 arising from the giving of interest-free loans by the appellant (the Taxpayer) to its subsidiaries are wholly and exclusively incurred in the production of gross income within the meaning of S33 of the Income Tax Act 1967 (ITA). (All sections cited hereafter are from the ITA unless otherwise stated.)

Among the facts admitted or proved before the SCIT are the following:

- The Taxpayer is an investment holding company. It has 9 direct subsidiaries and 8 indirect subsidiaries in YA 2002 and YA 2003.
- In 2002 and 2003, the Taxpayer borrowed from financial institutions for revolving credit facilities, hire purchase and finance leases and short term loans. Short term loans were taken to finance the business activities of the Taxpayer and its subsidiaries.
- Some of the subsidiaries were given interest-free loans but there were no details on which subsidiary received interest-free loans and which received interest-bearing loans.
- A field audit of the Taxpayer's accounts was carried out by the Respondent in April 2006. On 23.5.2006 the Taxpayer submitted revised tax computations and revised return forms for YA 2001 – 2003. The amount of interest expenses in the original tax computation and the revised tax computation for the relevant years are as follows –

Income Tax Computation	YA 2002	YA 2003
Original	1,187,248	1,329,198
Revised	2,336,804	2,569,830

- In the original tax computations for the relevant years of assessment, 'amount due from

subsidiaries' (under the item "Investments") was classified into "interest-free" and "interest-bearing". In the revised tax computations for those years, there was no such classification of the amount due from subsidiaries.

- The Respondent disallowed the interest claimed and explained in a letter dated 14.8.2006 that the claim cannot be allowed because the loans given to subsidiaries were interest-free loans. Referring to the *Multi Purpose* case, it went on to state that such loans cannot be regarded as an income source from which income can be derived. (Note - The case referred to is *MP Holdings Sdn Bhd v KPHDN (2000) MSTC 3115* and *KPHDN v Multi-Purpose Holdings Bhd [2002] 1 MLJ 22*)
- Based on the audit findings and the Respondent's approach to interest restriction, the assessments were issued under S91(1), being best judgment assessments of the Respondent. Being aggrieved by the assessments for YA 2002 and YA 2003, the Taxpayer appealed to the SCIT.

The appeal to the SCIT was dismissed. The Taxpayer then appealed to the High Court (the Court).

#### **Decision:**

Appeal dismissed. The grounds of decision are summarized below:

#### **1. Submissions**

1.1 The following are arguments submitted for the Taxpayer:

- Both interest-bearing loans and non-interest-bearing loans constitute a single source of income.
- Reference was made to the *Multi Purpose* case wherein the High Court held that 6 classes of income chargeable to tax are provided in S4 of the ITA. And "each source" in S5 means the sources set out in S4 which includes an "interest" source in S4(c). S4 has identified the subject matter of taxation as 'dividends' and 'interest' and Revenue did not have the authority to split this classification up in a manner that increased the taxpayer's liability to tax.
- Under S4(c), "dividends, interest or discounts" are grouped under one category. Hence, the principle that is applied to dividend is equally applicable to interest income. Just as dividends from all counters of shares, whether income producing or otherwise, are classified as a single source of income (based on the *Multi Purpose* case), so should all interest be treated as a single source, whether the loans are income producing or not.
- A witness for the Taxpayer had testified before the SCIT that the interest-free loans were not intended to be interest-free and that only when a subsidiary is in a profitable position would interest be charged. (However, the SCIT found that this contention was not supported by any evidence.)

1.2 The Respondent's contentions were as follows:

- Since an interest-free loan do not generate income, whether present or future, it is not a source of income and will never be a source of income so long as the loan is interest-free. Therefore, the interest expense was not incurred in the production of income at all.
- In disallowing the interest, the Respondent had accepted the Taxpayer's own classification of the amount due from subsidiaries as 'interest-free' and 'interest-

bearing' loans.

## 2. Decision of the Court

- 2.1 S33 provides that "all outgoings and expenses wholly and exclusively incurred..... in the production of gross income..." may be deducted from gross income from that source.

The Taxpayer had classified loans given into interest-bearing and non-interest-bearing loans, but gave no details on which subsidiary received what type of loan. The Court agreed with the Respondent and the SCIT that to allow the interest expenses incurred in respect of the loans taken by the Taxpayer from which interest-free loans were given to its subsidiaries would be contrary to the Act. The interest expenses incurred on loans which were utilized to give interest-free loans to subsidiaries were not "incurred...in the production of gross income" of the Taxpayer. Therefore, for the purposes of S33 it is necessary to distinguish between interest-bearing loans and non-interest-bearing loans.

- 2.2 On the contention that the principle that is applied to dividends is equally applicable to interest income, the Court agreed with the SCIT that there are separate provisions pertaining to dividend income (S14) and to interest and royalty income (S15). Principles that apply to dividend income would not necessarily apply to interest and royalty income merely because they are grouped in one category.

- 2.3 The Court is of the view that the facts of the *Multi Purpose* case are distinguishable from the present case. In that case, all the loans made to the related companies by the taxpayer were interest-bearing loans, which led to the High Court's conclusion that to further subdivide the source of income is to disintegrate the groupings further than is authorized by the ITA. In the present case, the Court has held that the subdivision of interest-bearing and non-interest-bearing loans is necessary for the purpose of S33.

Based on the above reasons, the appeal is dismissed.

Members may read the full Grounds of Judgment at the [Institute website](#) and the [LHDNM website](#).

### Disclaimer

This document is meant for the members of the Chartered Tax Institute of Malaysia (CTIM) only. This summary is based on publicly available documents sourced from the relevant websites, and is provided gratuitously and without liability. CTIM herein expressly disclaims all and any liability or responsibility to any person(s) for any errors or omissions in reliance whether wholly or partially, upon the whole or any part of this E-CTIM.