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TECHNICAL

Direct Taxation

TAX CASE UPDATE

Whether interest received by a Malaysian company from loans to a foreign company is tax exempt foreign source income received in Malaysia.

KPHDN v CARDINAL HEALTH MALAYSIA 211 SDN BHD

High Court Malaya at Kuala Lumpur
Appeal No: R1-14-12-2009

Date of Judgment: 22 Dec 2010

Facts and Issues:

This is the appeal by the Director General of Inland Revenue (the appellant) against the decision of the Special Commissioner of Income Tax (SCIT) who allowed the taxpayer's appeal against assessments for the years of assessment (YA) 1999 to 2005 raised by the appellant in respect of interest income received by the taxpayer from loans given to a Netherlands company.

The taxpayer is a company incorporated under the Companies Act 1965 with a registered address in Penang. During the YA under appeal, the company was carrying on a business of manufacturing and exporting latex and synthetic gloves. Allegiance Healthcare Holding BV (AHH) is a company incorporated under the laws of the Netherlands and carrying on business in that country. Both these companies belong to the Cardinal-Allegiance group.

AHH operates as a financing entity for the group. It is designated by the group as one of the central points to receive funds, and functions as treasurer for managing surplus funds in the group. This "central treasury function" enables entities within the group with surplus funds to invest the same by way of loans to AHH, which are repayable on "commercially competitive rates" (of interest).

The taxpayer entered into 3 agreements (effective 1998, 1999, and 2000 respectively) for the provision of loans/advances to AHH. The taxpayer invested surplus funds consisting of profits from its business activity by way of loans to AHH and in consideration, received passive income in the form of interest payments under the agreements. For the years of assessment 1999 to 2005, the taxpayer treated such interest income as tax-exempt on the basis that it is foreign source income. Prior to the self-assessment system, the appellant had accepted the interest income as a foreign source from the company's audited accounts.

However, as a result of a tax audit of the taxpayer's accounts, the appellant concluded that the interest income was not a foreign source income. The appellant then raised additional assessments on the taxpayer for YA 1999 (dated 11.01.2007), YA 2000(CY) to YA 2003 (all dated 29.12.2006), and YA 2005 (also dated 29.12.2006), and an original assessment for YA 2004 (dated 29.12.2006). Penalty was also imposed on these assessments.

In the appeal by the taxpayer to the SCIT against the above assessments, the issues for the SCIT's decision were:

1. Whether interest income received by the taxpayer from AHH for the years under appeal is tax exempt foreign source income received in Malaysia by virtue of S3 of the ITA, Income Tax (Exemption)(No. 48) Order 1997 and Paragraph 28, Schedule 6 of ITA; (all sections quoted hereafter refer to sections in the ITA unless otherwise stated.)
2. Whether the additional assessments for YA 1999 and YA 2000(CY) are time barred under S91; and
3. Whether the DGIR has correctly and reasonably imposed penalties on the taxpayer.

The SCIT referred to the cases of *C of IR v Hang Seng Bank Ltd [1991] 1 AC 306* and *C of IR v Orion Caribbean Ltd [1997] 2 HKC 449* and decided that the answer to the first question (above) is affirmative.

The DGIR appealed to the High Court ("the Court") against the SCIT's decision.

Decision:

Appeal dismissed. The grounds of decision are summarized below:

1. **Submissions**
   - The appellant submitted that determining a person's tax liability requires determining the source of the income [*OA Pte Ltd. V KPHDN (1996) MSTC 2752*]. It was contended that the interest income of the taxpayer was taxed based on the simple reasoning that the source of the interest income i.e. the "originating source" for the taxpayer's income is the funds provided for the loans which were garnered from the carrying on of its business in Malaysia. Hence "the originating and real source of the interest income is in Malaysia and not a foreign source income".
   - Counsel for the taxpayer submitted that the SCIT has found that the funds were transferred and made available to AHH outside Malaysia and used outside Malaysia. Therefore, interest derived is likewise outside Malaysia. The taxpayer received passive income by allowing AHH the use of its property and this is consistent with the broad guiding principle enunciated in the Hang Seng Bank case that "*one looks at what the taxpayer has done to earn the profit in question*." This principle is not restricted to cases involving trading income only. Passive income is derived by the mere exploitation of property such as by lending. Interest, which is the fruit of the money, is derived from where the money is lent. Referring to the case of *CIR v Lever Brothers & Unilever Ltd (1946) 14 SATC 1*, it was submitted that the source of the interest received by the taxpayer in the present case is the place where the taxpayer gave the loan/ supplied credit to AHH which is outside Malaysia.

2. **Authorities considered**

   The Court considered the following authorities, and highlighted the important principles established in each case:

   i. <u>*C of IR v Hang Seng Bank Ltd (supra)*</u>

   "….*The broad guiding principle attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question…But if profit was earned by the exploitation of property assets as by letting property, lending money…….the profit will have arisen in or derived from the place where the property was let, the money lent*…."

   ii. <u>*C of IR v Lever Brothers & Unilever Ltd (supra)*</u>

   "…*the source of receipts …(is)…the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the quid pro quo which he gives in return for which he receives them. …… Consequently this provision of credit is the originating cause or source of the interest received by the lender*."

iii. *C of IR (NZ) v N.V. Philips' Gloeilampenfabrieken [1955) N.Z.L.R. 868*

On the test for determining the source or derivation of income, reference was made to *Nathan v Federal Commissioner of Taxation (1918) 25 C.L.R. -*
"*The Legislature in using the word "source" meant, not a legal concept, but something which a practical man would regard as a real source of income…But the ascertainment of the actual source of a given income is a practical, hard matter of fact."*

3. **Decision**

- Having considered the above authorities and the submissions of both parties, the Court agreed with counsel for the taxpayer and took the view that the funds *per se*, do not produce the interest income, but it is the supply or provision of credit, and not the source of the credit, which is the originating cause or source of the interest received by the lender (referring to the quote from the Unilever case). In the present case, it is the transaction or activity undertaken by the taxpayer which is the provision of loans to AHH that is the originating cause that produced the interest income.
- The Hang Seng Bank case and the Orion Caribbean Ltd case show that the source of interest on a loan is determined on where the money was lent. In the present case. The agreements entered into between the 2 parties were not made in Malaysia. The taxpayer lent the money to AHH in the Netherlands. Thus the interest income received by the taxpayer in Malaysia were not income accruing in or derived from Malaysia but derived from sources outside Malaysia.
- The SCIT had correctly concluded that the interest income sourced in the Netherlands by the taxpayer can only be said to be sourced outside Malaysia. The Court found no error in the SCIT's decision.

Members may read the full Grounds of Judgment at the Institute's website and the LHDNM website.