IN THE MATTER OF INTEREST

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"Interest is the monetary charge for the privilege of borrowing money, typically expressed as an annual percentage rate. Interest is the amount of money a lender or financial institution receives for lending out money. Interest can also refer to the amount of ownership a stockholder has in a company, usually expressed as a percentage."[1]

"Interest" is defined as the return or compensation for the use or attention by one person of a sum of money belonging to or owed to another in Halsbury's Laws of England. In *Riches v Westminster Bank Ltd (1947) AC 390*, Lord Wright observed that "interest is payment which becomes due because the creditor has not had his money at the due date. It may be regarded either as representing the profit he might have made if he had had the use of the money, or conversely the loss he suffered because he had not that use".

In the Malaysian tax landscape, there is no statutory definition of interest given in the Malaysian Income Tax Act 1967 (MITA).

This article seeks to examine on the type of interest income which is chargeable to tax in Malaysia and, on the flip side, on whether interest expense incurred is deductible against the gross income.

INTEREST INCOME – BUSINESS OR NON-BUSINESS SOURCE

Generally, interest income is chargeable to tax under Section 4(c) of the MITA. However, certain types of income are also taxed as business income under Section 4(a) of the MITA. Several cases went to the courts in Malaysia to debate the fact of whether interest income should be treated as part of the business income or taken to be passive investment income. Among the notable cases are *Ketua Pengarah Hasil Dalam Negeri v Pan Century Edible Oils Sdn Bhd (2002) MSTC3967* and *I(M) Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri (2005) MSTC 3,609*. Following this, a new Section 4B was introduced in the MITA which provides that interest income shall be treated as business income only if the debenture, mortgage or other source to which the interest relates forms part of the stock-in-trade of a business of a person or the interest is receivable by a person from the business of lending money and that business is one which is licensed under any written law. This new Section 4B of the MITA which came into effect from the year of assessment (YA) 2013, effectively means that any interest, other than interest received by financial

institutions (banks and so on), shall not be treated as business income.
Further to the introduction of Section 4B, the Inland Revenue Board of Malaysia (IRBM) has issued Public Ruling (PR) 3/2016 on "Tax Treatment on Interest Income Received by a Person Carrying on a Business", which provided explanation on the tax treatment in respect of interest income received by a person carrying on a business. Among the examples of interest income mentioned in PR 3/2016 that cannot be treated as business income from YA 2013 are interest charged due to delay in payment of trade debt, interest from an easy payment plan, interest from fixed deposit placed as security and interest received by a person from loan given to employees. With the introduction of Section 4B of the MITA, the question arises as to whether the fundamental tax principle of any income receivable incidental to and in the course of carrying out a business activity should be treated as part of that business income is still in place?

INTEREST INCOME - WHEN IS IT DERIVED?

The derivation of interest income is governed under Section 15 of the MITA. Generally, only interest derived from Malaysia is subject to tax in Malaysia. Any foreign sourced interest income is exempted from tax. When the interest income is derived from Malaysia, how will it be recognised as a taxable income? Section 27(1) of the MITA lays out that where interest first becomes receivable in the relevant period, it shall, when it has been received, be treated as gross income of the relevant person for the relevant period. Interest must be treated as being received by a person at the time when the person is entitled to the interest income accruing in or derived from Malaysia and is able to obtain the receipt thereof on demand [Section 29(1) of the MITA]. This means that the interest income is taxable even though the interest has not been received yet.

With effect from YA 2014, pursuant to Section 29(3) of the MITA, interest on loan transactions between related parties is deemed obtainable on demand when the interest is due to be paid. The introduction of this anti-avoidance provision is to tighten the provision in order to bring the interest income to tax at the same time as the interest would be claimed as a deduction by the borrower. Sections 29(3) and (4) of the MITA were put in place to deem that the lender is able to obtain payment on demand when the interest is due to be paid and the interest expense is deductible only when the expense is due to be paid. While Sections 29(3) and (4) of the MITA address the timing of recognition of interest, the timing of deductibility amendments are covered in Sections 33(4) and (5) of the MITA.

DEEMED INTEREST INCOME FROM LOANS OR ADVANCES TO DIRECTOR

At times, companies may extend loans or advances to its directors either from its internal funds or from external borrowings. These loans or advance would generally be free of interest as there is no additional funding incurred by the company. By virtue of Section 224 of the Companies Act 2016, a company (other than an exempt private company) is explicitly prohibited from providing a loan to a director of the company or of a related company except in certain situations. Effective from YA 2014, Section 140B of the MITA was introduced to deem the interest income from loans or advances to directors as taxable income of the lending company. The IRBM also issued PR8/2015 on "Loan or Advances to Director by a Company" to explain on the tax treatment of interest income deemed to be received by the company from the loans or advances to directors of the company without interest or with interest rate lower than the arm's length rate. The interest income for the basis period for a year of assessment shall be the aggregate sum of monthly interest in the basis period, computed in accordance with the following formula:
1/12 x A x B

where A is the total amount of loans or advances outstanding at the end of the calendar month, and B is the average lending rate of commercial banks published by the Central Bank at the end of the calendar month, or where there is no such average lending rate, such other reference lending rate as may be prescribed by the Director General.

The Tax Policy Department of the IRBM has clarified that Section 140B of the MITA is applicable to directors of the company (as defined in Section 75A(2) of the MITA and to loans or advances which are financed by the company's internal funds only. It does not apply to loans/advances funded from external loans or loans from third parties.

INTEREST INCOME DURING THE MORATORIUM PERIOD

Under the Prihatin Rakyat Economic Stimulus Package, a moratorium was approved by banks or financial institutions on repayment of loans or financing for the period form 1 April 2020 until 30 September 2020. The Income Tax (Special Treatment for Interest on Loan) Regulations 2020[P.U.(A) 237] were gazetted on 25 August 2020 to set out the tax treatment of interest due and payable in respect of loans related to the moratorium programme. In this regulation, the loan is granted by a bank or financial institution to an individual, small and medium enterprises (SMEs) or any company other than an SME. Such interest due on a loan will not constitute gross income of the bank or financial institution for the YA. However, where

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

interest on such loans is received from 1 April 2020 to 30 September 2020 or becomes receivable on or after 1 October 2020, such interest will constitute gross income of the bank or financial institution. The Regulations also provide that no deduction from the gross income of a financial institution is allowed under the MITA based on any impairment of a loan involved in the period of the moratorium programme. A separate account is to be maintained for the amount of interest and payment received under the moratorium programme.

INTEREST EXPENSE – DEDUCTIBILITY RULE

Section 33(1)(a) of the MITA states that 'any sum payable for that period (or for any part of that period) by way of interest upon any money borrowed by that person and -

(i) employed in that period in the production of gross income from that source, or

(ii) laid out on assets used in or held in that period in the production of gross income from that source;'

Based on the reading of the law, interest expense is deductible when it is incurred in the production of income. The purpose of borrowing the money is an essential factor to consider when determining the deductibility of this type of expense. Typically, if money is borrowed for general working capital or purchase of fixed assets, the interest paid on the indebtedness would qualify for deduction. However, the deductibility of certain types of interest expense may be impaired by the operation of anti-avoidance provisions such as Section 33(2) of the MITA. This provision provides for a restriction of the interest deductible where a person borrows money for business purposes, but the money is partly used to finance non-business operations.

INTEREST EXPENSE – WHEN IS IT DEDUCTIBLE?

The question on the timing of deductibility of interest expenses was addressed with effect from YA 2014 through Section 33(4) of the MITA. A taxpayer is only eligible to claim a deduction in respect of the interest expense when such interest is due to be paid. When interest expense becomes "due to be paid", the taxpayer must relate the interest expense to that period for which it was payable. Thus, the deduction would be given in the year the interest is payable. Following the inclusion of this provision in the MITA, the IRBM has issued PR 9/2015 on "Deduction of Interest Expense and Recognition of Interest Income for Loan Transactions Between Related Persons" which explains on the deduction of interest by the borrower. Subsequent to that, a new Section 33(5) of the MITA was also included to address the compliance aspects of the claiming the tax deduction on the interest expense. The taxpayer will have to initiate the process of notifying the IRBM in writing not later than twelve (12) months from the end of the basis period for the YA when the sum is due to be paid with the amended tax computations for the prior YAs to claim interest deductions in the respective YAs. Subsequently, the IRBM will review and confirm the deductibility of the interest expense before the assessments for each YA is amended to allow the claim.

INTEREST EXPENSE DURING THE MORATORIUM PERIOD

As mentioned in the paragraph above, the interest income of the bank or financial institutions under the moratorium would only be taxable when the interest income is received after the moratorium period. How about

the deductibility of the interest expense incurred by individuals and SMEs during the moratorium period? Having looked at the provisions of Section 33(4) of the MITA above, the interest expense is deductible when such interest is due to be paid. Effectively, the moratorium period only allows for payments to be deferred and it doesn't change the due to be paid date. Therefore, the interest expense would be deductible based on the due to be paid date as set out in the loan agreement between the financial institutions and the borrower. However, the situation may be different if the parties have initiated to amend the original loan agreement to vary the due dates.

RESTRICTION ON INTEREST DEDUCTION

To restrict the deductibility of interest in relation to financial assistance in controlled transactions, Section 140C of the MITA was introduced in the 2018 Budget announcement. Following that, the Income Tax (Restriction on Deductibility of Interest) Rules 2019 (Rules) was gazetted for the implementation of Section 140C of the MITA. The Rules which came into operation on 1 July 2019 provides that there is now a maximum threshold on the allowable deduction on interest expense for a YA in the context of group financing. The maximum amount of interest expense allowed is 20% of the tax-EBITDA (earnings before interest, taxes, depreciation and amortisation) of a taxpayer from each of his sources consisting of a business for a YA. The tax-EBITDA is determined as follows:

A + B + C

Where:

(a) "A" is the amount of adjusted income of a taxpayer before any restriction on deductibility of interest;

(b) "B" is the total amount of qualifying deductions allowed; and

(c) "C" is the total amount of interest expense incurred in relation to the gross income of the taxpayer for any financial assistance in a controlled transaction.

Interest restriction is inapplicable where the total amount of interest expense in respect of all financial assistance is equal to or less than RM500,000 in a YA. In addition, the Rules do not apply to selected classes of taxpayers, namely, individuals, banks, insurers, development financial institutions, construction contractors and property developers. In relation to the Rules, the IRBM published its Guidelines on Restriction on Deductibility of Interest on 5 July 2019 (the Guidelines). The Guidelines provide detailed explanation into the interpretation of the Rules by the IRBM together with examples of how the Rules will be applied. However, the Guidelines have no legal effect. There are inconsistencies in relation to the scope in covering the domestic and cross-border related party financial assistance as depicted by Section 140C of the MITA, the Rules and the Guidelines. The Guidelines appear to limit the scope of the restriction on the deductibility of interest to cross-border transactions only. However, the wording of Section 140C of the MITA seem to have a wider scope which covers both domestic and cross border related party financial assistance. Following the issuance of the Guidelines, can the IRBM decide to expand the scope of Section 140C of the MITA to cover domestic financing arrangements as well? Although the Guidelines do not have the force of law, are they binding on the Director General of Inland Revenue? In light of the restriction on the deductibility of interest in relation to financial assistance in controlled transactions, taxpayers in Malaysia with cross-border financing arrangements should ascertain whether their interest expense exceeds 20% of their tax-EBITDA and ensure compliance with the provisions of the MITA and the Rules.

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CONCLUSION

In conclusion, it is evident from the above analysis of the tax treatments of interest in Malaysia that the law has changed significantly. Generally, interest income is subject to tax when it is received, and interest expense is deductible when it is incurred. In the event of a loan between related parties, anti-avoidance provisions will be invoked to synchronise the deduction of interest expense with the taxing of the interest income. The tax law relating to interest will continue to evolve with the various types of transactions carried out by individuals, companies and organisations. All stakeholders must work hand-in-hand to ensure that the tax collection and tax compliance process benefits the nation as a whole. Frequent dialogues and discussions must be held between the tax authorities, taxpayers, tax agents and the business owners before a new tax law is implemented.

Disclaimer: This article does not seek to address all issues associated with interest income and interest expense. All views expressed herein are purely the personal opinions of the authors.

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