Issue 128
November 2016

PP 9741/10/2012 (031262)

PwC Alert

Deductibility of borrowing costs

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This article briefly examines the intricacies of tax treatments for borrowing costs.

First principles

Income tax law is developed from one simple concept: it includes revenue and excludes capital. The computation of taxable profits from business is the sum of gains that is revenue in nature after deduction of expenditure that is revenue in nature. Expenditure that is capital in nature is not deductible.

The distinction between revenue and capital has always been fraught with one simple yet elusive problem – definition. Tax statutes do not define them and one can only rely on principles established from a multitude of case laws. Tax deduction for borrowing costs is also not spared from this capital-revenue determination.

Capital expenditure: Is it capital in nature?

> *When an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade ... there is a very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as attributable not to revenue but to capital.*
>
> (British Insulated and Helsby Cables, Limited v Atherton [1926] AC 205)

> *A benefit which endures, in the way that fixed capital endures; not a benefit that endures in the sense that for a good number of years it relieves you of a revenue payment. It means a thing which endures in the way that fixed capital endures... the Commissioners, with great respect, have been misled by the way in which they have taken "enduring" to mean merely something that extends over a number of years.*
>
> [Anglo Persian Oil Co, Ltd v Dale (HM Inspector of Taxes) (1931) 16 TC 253]

These are some of the key principles often quoted in the courts to ascertain whether an expenditure is capital in nature. Expenditures which are not viewed to be capital in nature based on such principles would, on the other hand, be viewed as revenue in nature.

Types of borrowing costs

Borrowing costs are simply expenditures incurred by businesses in relation to money borrowed. The material costs in respect of a simpler loan facility, especially for smaller sums of money, would simply be interest charged by the lender. Any other related costs could be negligible.

On the other hand, expenditure in relation to more complex facilities such as bonds and syndicated loans would in addition to interest, include other significant costs.

Some are to be incurred one-off and some periodically throughout the lifecycle of the facility. Typically, these would include:

- Arranger/agency fees
- Underwriter's fees
- Lawyer fees
- Stamp duty
- Valuation fees of collaterals
- Discount on issuance
- Premium on redemption
- Early redemption fees
- Guarantee fees
- Currency exchange losses (collectively, "other borrowing costs")

The prescribed deduction for interest

The Malaysian Income Tax Act 1967 ("Act") specifically singles out interest expense incurred under some circumstances to be deductible. Typically, interest expense arising from borrowing used for general working capital or purchase of fixed assets would qualify for this prescribed deduction. Where part of the borrowing is used for passive investments, interest expense proportionate to such part would be deductible against income arising from such investments, if any.

Treatment for other borrowing costs

The deduction for these costs are contentious because unlike interest, they are not specifically stated in the Act. In view of this, the deductibility would need to pass at least the "incurred in the production of income" test under the general deduction provision in the Act [Section 33(1)] and not capital in nature at the same time. This is where guidance has to be referred from principles established from case laws to determine whether they are revenue or capital in nature.

The courts' approaches for other borrowing costs

The approaches commonly adopted are:

1. Financing activities vs. business activities

This approach, explicitly or otherwise, argues that the financial activities have a predisposition of capital nature; that financial arrangements are distinct and separate from the trading operations (which is revenue in nature). In the language of the general deduction rule, this argument proposes that financing is not "in the production of income".

In *Ketua Pengarah Hasil Dalam Negeri v. Seabanc Kredit Sdn Bhd (1998) MSTC 3695,* the Special Commissioners of Income Tax ("SCIT") held that owing to the business activity of the taxpayer as a financier, funds raised to be on-lent are analogous to trading stock (which is revenue in nature) and as such it follows that other borrowing costs incurred to acquire the funds are deductible. On appeal by the Inland Revenue Board ("IRB"), the High Court disagreed and held that costs incurred to raise funds are capital in nature notwithstanding the taxpayer's business activities. Ultimately, the Court of Appeal ("CoA") has held that such costs are deductible. Unfortunately, the CoA did not provide the grounds of its decision.

Therefore, financing arrangements need not necessarily be viewed as distinct and separate from trading operations. For example, in the case of *Comptroller of Income Tax v IA [2006] SGCA 24*, the Singapore's CoA held that other borrowing costs incurred to raise funds to construct a property for sale are deductible under Section 14 of the Singapore Income Tax ("Singapore Act"). Section 14 of the Singapore Act is similar to Section 33(1) of the Act. In holding the treatment, the Singapore's CoA propounded that a "wider nexus approach" should be adopted and that "*In determining whether this nexus is present, the business has to be looked at as a whole set of operations directed toward producing income…*".

2. Same footing/analogous with interest

In *FCD Sdn Bhd v. Ketua Pengarah Jabatan Hasil Dalam Negeri (1995) 2 MSTC 2181* ("FCD"), the Special Commissioners of Income Tax held that the guarantee fees and interest are linked. These are an integral part of the loan package and are deductible. The taxpayer is a property developer and the underlying loan was obtained to construct properties for sale.

The High Court held in the case of *Fernrite Sdn Bhd v. Ketua Pengarah Hasil Dalam Negeri (2004) MSTC 4,065* ("Fernrite") that guarantee fees are "analogous" to interest expense and are deductible. In this case, the taxpayer was in the business of buying and selling shares and had incurred guarantee fees in respect of borrowings used to purchase shares.

In spite of the above decisions, the IRB continued to maintain its position that guarantee fees incurred by property developers are not deductible as set out in its Public Ruling No. 1/2009 – Property Development.

In the case of *BFC v Comptroller of Income Tax [2014] SGCA 39*, Singapore's CoA has, in deciding whether discount and premium expenses qualify for deduction under Section 14 of the Singapore Act, rejected the taxpayers' argument that the "meaning of interest" is wide enough to include premium and discount expenses. Note: The Singapore Act has now been amended to also prescribe premium and discount expenses as deductible alongside interest.

It should be noted that the argument that the "meaning is wide enough to include" could be distinguished from the "analogous" arguments in FCD and Fernrite.

In MVSB v KPHDN (unreported), the SCIT held that discount and premium expenses incurred by an investment holding company are deductible under the general deduction rule of Section 33(1) in spite of a prescribed deduction rule for discount and premium expenses which was not applicable to the taxpayer.

In MVSB v KPHDN, Section 34C of the Act specifically prescribes the deduction for discount and premium expenses. However, Section 34C did not apply unless the taxpayer derived discount or premium income at the same time. This was not the case. The taxpayer derived dividend income instead. The IRB argued that discount or premium expenses can only be deductible under Section 34C and that ultimately the taxpayer is not entitled to any deduction. This follows on from the taxpayer's failure to meet the condition under Section 34C because it did not derive any discount or premium income. Among others, the SCIT, held that Section 34C is inapplicable to the taxpayer but the discount and premium expenses are deductible under the general deduction rule of Section 33(1).

Note: The scope of deduction under Section 34C has since been amended to include discount and premium expenses arising from funds raised and used for the purpose of a business with effect from the year of assessment 2011.

Nature of the underlying borrowing

It could be argued that borrowing costs by themselves are not revenue or capital in nature and that their nature is derivative, that is, the costs would depend and follow the nature of their underlying transaction, i.e. the borrowing itself. Therefore, it is the nature of the borrowing itself that is often debated before the courts in ascribing revenue/capital character to borrowing costs.

In the case of *Bedford Damansara Heights Development Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* (unreported), the High Court held that borrowings taken to finance the construction of a building to be rented out are capital in nature as its underlying purpose was to finance the construction of an investment property to earn rental income. As such investment property is part of the taxpayer's fixed capital, it follows that the borrowings will derive a capital nature. Therefore, guarantee fees will also derive the same capital nature and are therefore not deductible.

The Government's selective certainty by way of tax incentives

The Government has issued various incentives for the deduction of costs incurred to raise bonds/debentures/sukuk. The lists include the *Income Tax (Deduction for Expenditure on Issuance of Retail Debenture and Retail Sukuk) Rules 2013* and the *Income Tax (Deduction for Expenditure on Issuance of Agro Sukuk) Rules 2013*, to name a few.

Such incentives promote the issuance of the specified bonds/debentures/ sukuk (collectively, "bonds") as it provides certainty of tax deduction for costs incurred to raise such bonds apart from interest. However, these incentives may create or perpetuate the perception that borrowing costs are necessarily capital in nature owing to its predisposition. To the uninitiated, they may imply that in the absence of such incentives, the Act, i.e. Section 33(1) cannot allow deduction for other borrowing costs apart from interest.

The silver lining for other borrowing costs for taxpayers

The body of case laws such as those mentioned suggests that other borrowing costs, although may be preconceived as capital in nature, need not always be the case. Depending on the facts of the case, they could be revenue in nature, part and parcel of the process of producing income, or analogous to interest and hence deductible.

Let's talk

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