



# A Matter of Interest

## Key Issues Relating to the Tax Deduction of Interest

By Kang Beng Hoe

### Introduction

In a global environment where debt financing by governments and private enterprises are entrenched features of all modern economies, interest represents by far the most common and critical expense of businesses. Gordon Brown the former British prime minister summed it up by saying that modern capitalism cannot flourish without leverage. In a cynical comment, Phillip Coggan<sup>1</sup> lamented, that “in the last forty years, the world has been more successful at creating claims on wealth than it has on creating wealth itself.”

### Economic rationale for granting tax deduction

The granting of tax deduction for interest is a double-edged sword. On the one hand, governments recognise its economic benefit in serving to incentivize the accumulation of capital, which in turn will generate income. On the other hand, the deduction for interest, from the perspective of the tax collector, “is the most dangerous of all deductions. Unless properly curbed, it will allow taxpayers to deplete their current taxable income by accelerating their deductions for capital costs into the current period, by generating artificial losses, by converting personal expenditures into deductible costs of earning income, and by pushing their income offshore. In the long run, a country that does not impose

appropriate limitations on the interest deduction is out of the tax collection business.”<sup>2</sup> This in large part accounts for the complexity of the tax deduction rules adopted by many countries.

### Definition of interest

“Interest” is generally not defined in most countries’ tax law. There is indeed no definition of the term in the Malaysian Income Tax Act, 1967. The term derives its meaning from judicial pronouncements in a number of court decisions in Commonwealth countries. Succinctly, it is said to represent compensation for the use of money. One of the leading cases on the definition of interest is the UK case of *Westminster Bank Ltd v. Riches* (28 TC 159). This case, which involved the award of damages to the bank, prompted Lord Wright to state that:

“...the essence of interest is that it is a 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 the use of the money or conversely the loss he suffered because he had not had that use. The general idea is that he is entitled to compensation for the deprivation.”

Amounts, which are economically equivalent to interest, such as discount, may or may not be treated as interest for tax purposes. Countries such as Malaysia, which give prominence to a transaction’s legal rather than economic substance in their tax law, would not treat such discount as interest.

<sup>1</sup> “Paper Promises: Debt and the New World Order”

<sup>2</sup> Professor Michael J McIntyre, Wayne State University Law School.

Interest differs from dividends in respect of the underlying characteristics; interest is paid on debt whereas dividends are paid on equity, although the difference between debt and equity can sometimes cause problems.

## General rules for deductibility of interest

Most countries' tax systems permit the deduction of interest as a cost of earning income. This general rule is simple enough until one considers the variety of ways for linking interest for the purpose of distinguishing:

- between income earning activities and personal consumption. Almost all tax systems do not allow interest to be deducted where the funds are used for personal, non-business expenditure.
- between generic sources of income. This is where a tax system adopts the scheduler basis for taxing income. Under such a basis, income is taxed according to a source and interest and other expenses are deducted based on their being attributed to each income source.
- between geographic sources of income. This is relevant under a tax system which taxes income on a territorial scope as opposed to a world- wide scope.

## Generic rules for attributing interest to income

In his 1981 seminal paper "An enquiry into the Special Status of Interest Payments", Professor Michael J. McIntyre analysed the principles relative to the linking of interest expense to personal consumption or to generic or geographic sources of income. These rules are widely applicable although, with the exception of the U.S., they have not been given much focus by many countries' tax systems.

Professor McIntyre emphasized the relevance of these rules. "I contend that the deductibility of all expenditure should depend on the use made of the assets (including goods and services) ultimately obtained from those expenditures. The assets ultimately obtained from an interest payment are the assets obtained from the proceeds of the loan with respect to which interest was paid."

There are two fundamental approaches for linking or attributing interest to the various sources of income or to personal consumption. They are the tracing method or the allocation method. These are used to determine whether deduction of

interest should be restricted. Virtually every tax system today adopts features, which link deductions with particular items of income.

## Tracing method

Under this method, the actual use of the borrowed money is determined based on all relevant facts and circumstances. If the money is used for a qualifying purpose, the interest is deductible; otherwise it is not.

The issue then is to determine whether the use of the borrowed funds is the first use or final use.

Generally the use of money borrowed to defray business costs such as paying salaries or for acquiring services, would constitute both first use and final use.

More often, the first use of borrowed money is not its final use. The acquisition of property from borrowed money involves its continuing use until the property is disposed of. When this happens, tracing would require to be used to determine the continuing use of funds.

Where borrowed funds, which have been used for income producing activities, are replaced by new borrowings, this would also constitute continuing use. This rule has been followed by the Australian court<sup>3</sup> as well as the High court in Malaysia. In Malaysian case<sup>4</sup> the taxpayer took a second loan to pay off the first loan and it was contended by the Revenue that interest on the second loan was not deductible. Charles Ho J. deciding for the taxpayer said, "It follows, as a matter of logic and common sense that since interest payments on the first loan were deductible (conceded by Revenue) because they fall within the provisions of s 33(1)(a) of the Act, interest payments on the second loan would also be deductible for income tax purposes.

This approach of linking to the first debt is known as the historical method.

## The allocation method

In situations where tracing is not possible the allocation method is used. Under this method, a business is assumed to have borrowed funds for both qualifying and non-qualifying purposes. It involves an assumption about the use of borrowed money; the actual use of the funds is irrelevant. Inherent in the allocation method is recognition that money is fungible.

The allocation formula used may be specified in the tax law, or where it is not, the allocation is based on book value, tax cost or fair market value of the assets.

<sup>3</sup> *FC of T v JD Roberts (92 ATC 4380)*

<sup>4</sup> *Rakyat Berjaya Sdn Bhd v DGIR (1999) MSTC 3731*



## Sequence in linking usage of borrowed money

Under the tracing approach, the ordering or sequence of transactions is crucial. Where a taxpayer borrows funds to pay for his holiday, but retains his income producing investments, the interest on the borrowings would not be deductible. However, if he sells his investments to pay for his holiday and then borrows to buy them back, the interest on the borrowings would be deductible against his investment income. The thrust of the tracing rules rests on the actual usage of the borrowed funds.

The tracing method inevitably raises a subsidiary question. In what order should the borrowed funds be considered to have been used first. This first use is generally easy to determine. Sometimes the first use will be the final use as in the case where money is borrowed to pay for one's holiday or where a business borrows to pay for services.

More often first use is not the final use. In these situations, it is the current or continuing use of the borrowed funds, and not its first use, which is usually significant for establishing tax deductibility.

If the borrowed funds are traced to the purchase of a particular property, the tax deduction is allowed based on the use of the property; a determination of fact. If, however, the property is sold in whole or in part, tracing must once again be carried out to determine the use of the borrowed funds. This will involve ascertaining what the taxpayer does with the proceeds from the sale of the property. Thus tracing most often arise from the

acquisition of property with borrowed money. The onus in demonstrating the use of funds therefore, falls on the taxpayer and not the tax authorities, who will not normally have access to the necessary information.

The two ordering rules under the tracing approach are the 'positive' and 'negative' ordering rules. These require assumptions to be made as to the order in which borrowed funds are used for qualifying and non-qualifying purposes. When these ordering rules are used, the actual order in which the borrowed funds are used is irrelevant.

The 'positive' ordering rule assumes that money is borrowed to the maximum for qualifying purpose and only the excess is for non-qualifying purpose.

Under the 'negative' ordering rule, borrowed money is assumed to have been used to the maximum for non-qualifying purpose and the excess for qualifying purpose.

Thus if a taxpayer has income earning assets of 1000 and borrows 1500 to buy personal use property, under the 'positive' ordering rule he would be deemed to have used 1000 of the borrowed funds to acquire his income earning assets and 500 for personal consumption.

Under 'negative' ordering, his borrowings would be assumed to be wholly used for buying the personal use asset so that no part of the interest would be deductible.

Under apportionment rules, money is assumed to have been used for both qualifying and non-qualifying purposes and apportionment is in accordance with a formula rather than an ordering rule. In the above example, the taxpayer would be considered to have used 900 of the borrowed funds ( $1500 \times 1500/2500$ ) to acquire personal use property and 600 of the borrowed funds to acquire income-earning assets ( $1500 \times 1000/2500$ )

The results of applying these three methods to the example may be seen as follows:

	Positive ordering	Negative ordering	Apportionment
Amount borrowed	1,500	1,500	1,500
Eligible assets	1,000	1,000	1,000
Ineligible assets	1,500	1,500	1,500
Borrowings allocated to eligible assets	1,000	nil	600
Borrowings allocated to ineligible assets	500	1,500	900

## Timing of interest deductibility

In general, interest may be deducted when paid (the cash basis), in the year it is incurred or payable (the payable method) or in the year it is accrued (the accrual method).

Interest is payable when the borrower has an unconditional legal liability to pay the interest despite the obligation to pay is in the future.

If a loan is made where the borrower has a legal obligation to pay interest each day, then payable and accrual is synonymous. However if the terms of a loan specifies that interest does not arise until the borrower has had the use of the funds for the specified period, then it can be argued that interest has accrued over the period but will not be deductible until the end of that period when it becomes payable.

## The Malaysian statutory provision

The framers of the Malaysian tax legislation viz: Income Tax Act, 1967 have reflected some of the above generic rules in certain of its provisions. The main tranche of the interest deductible provision is Section 33(2). The section permits the deduction of interest upon money borrowed and:

- (i) “employed in that period in the production of gross income from that source; or
- (ii) laid out on assets used or held in that period for the production of gross income.”

The test for deductibility adopted here is the use of the borrowed funds, not as in some countries, the purpose in using the funds or the requirement that the use of borrowed funds should produce gross income.

Section 33(2) is a widely used provision to restrict the deduction of interest against income from a business in certain situations. Its operation involves the application of the tracing approach as well as the apportionment rule.

The words “...it appears to the Director General that..the investment or any part thereof has been financed wholly or partly or directly or indirectly out of borrowed money..”

means that the Director General is empowered to make an assertion as to how the borrowed money has been used. Consequently the onus is on the taxpayer to rebut that assertion. This would require tracing the use of the money borrowed.

If the assertion by the Director General is not fully rebutted i.e. if the borrowed funds cannot be traced to a particular use, then

computation of the amount of interest to be restricted would need to be made based on the apportionment formula laid down in Section 33(2).

In summary, whilst generic rules on interest attribution have been adopted by a number of countries, the prime example of which is the U.S., Malaysia has yet to use them, apart from encoding the apportionment method within Section 33(2) of the Income Tax Act. With the coming into full force of the single-tier imputation system post- 2013, and the impact of the restriction imposed under Paragraph 12B of Schedule 6, it will be timely for the rules to be focused on by the tax authorities with a view to issuing Public Rulings based thereon.

(This commentary has benefitted from the country reports appearing in the 1994 Cahiers of the International Fiscal Association)

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