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PRODUCTION OF BANKERS' BOOKS UNDER THE BANKERS' BOOKS (EVIDENCE) ACT 1949

by Syafinaz Vani and Elani Mazlan

The Financial Services Act 2013 ("**FSA**") came into force on 30 June 2013 and provides for the regulation and supervision of financial institutions. The FSA was also enacted with the purpose of upholding banking secrecy by making it an offence to disclose information including any documents received by financial institutions from its customers, thereby making it mandatory for banks to protect the rights and interests of consumers of financial services and products. This duty of secrecy is especially provided for under Section 133(1) of the FSA.

Recently, in the case of ***Protasco Bhd v Tey Por Yee & Anor and other appeals*** **[2021] 6 MLJ 1,** the Federal Court deliberated on the issue of whether the Bankers' Books (Evidence) Act 1949 ("**BBEA**") empowers the Court to order the production and/or disclosure of bankers' books in legal proceedings independently of Order 24 of the Rules of Court 2012 ("**ROC**") and further, the definition of 'banker's books' in the BBEA. In doing so, the Federal Court had taken into consideration the extent of the banking secrecy laws stipulated under the FSA.

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Brief Facts

Protasco Berhad ("**Protasco**"), a public listed company, commenced a suit in the High Court against two of its former directors and a company (which was alleged to be under the control of the two former directors) for an alleged conspiracy by the said directors and company to defraud Protasco and injure its business. In addition, Protasco's claim against its former directors was also based on breaches of their fiduciary duties owed to Protasco. Protasco sought to recover a sum of USD 27 million from the defendants.

In its action at the High Court, Protasco had made an application for discovery pursuant to Section 6 and/or Section 7 of the BBEA and/or Order 92 Rule 4 of the Rules of Court 2012 ("**ROC**") to inspect and take copies of all documents in the possession of Maybank Bhd and CIMB Bank in relation to the bank accounts belonging to its two former directors ("**Discovery Application**"). Protasco's application was grounded on the argument that such information and documentation sought would reveal the money trail in which Protasco's monies were ultimately channelled back to the said former directors. The two former directors opposed the said application on the basis that Protasco could not use the BBEA as a method of obtaining discovery. Instead, Protasco ought to have obtained an order for discovery under Order 24 of the ROC, specifically Rule 7A, and thus, the provisions in the BBEA could not be used to circumvent the rules of discovery provided for in the ROC. It was also argued that Protasco's Discovery Application was a fishing expedition and therefore, an abuse of court process.

Pursuant to the Discovery Application, Protasco had also made an application to admit the abovementioned discovered banking documents as evidence and marked as exhibits pursuant to Sections 2 to 6 of the BBEA and/or Order 92 Rule 4 of the ROC 2012 ("**Admission Application**"). This application was opposed on the following basis:

(1) the disputed documents which Protasco sought to admit and/or take as evidence and mark as exhibits were not derived from sources which fulfil the definition of 'banker's books' under Section 2 of the BBEA and therefore, the contents of these disputed documents could not be said to fall under the purview of the BBEA; and

(2) none of the disputed documents had been proven as required under the BBEA, specifically Sections 4 and 5 of the BBEA.

Furthermore, it was argued that since the disputed documents sought are not within the scope of the BBEA, a disclosure of the same would be in breach of the banking secrecy laws under the FSA.

The High Court's Decision

The High Court had allowed Protasco's Discovery Application. In this regard, the learned High Court Judge found that the BBEA provided an alternative and/or specific means of discovery in respect of bankers' books and entitled Protasco to seek inspection of banker's books and further, make copies of entries in such books in order to obtain evidence of the

purported flow of funds to its two former directors. While the High Court acknowledged to be indisputably true that the intention behind the enactment of the BBEA is to provide relief to bankers from the inconvenience of having to attend trial and produce their ledgers and other books in legal proceedings, it also found that the BBEA provides a right of inspection over bankers' books alongside a right to obtain copies of entries in those books.

In addressing Protasco's Admission Application, the High Court held that the said application could not be allowed on the following grounds:

(i) the court must first make a determination whether a document sought to be adduced comes within the definition of 'banker's books'. This is a mixed question of fact and law, and it may not be obvious from the face of every document. Accordingly, evidence may have to be led as to the purpose for which the bank had generated, or maintained a record of, the document in question; and

(ii) once this determination is made, the plaintiff must satisfy the court that:

(a) in the case of a copy of an entry in banker's book, the requirements of ss. 4 and 5 of the BBEA have been fulfilled; and

(b) in any other case, the requirements relating to proof of a document and its relevancy and admissibility have been fulfilled.

The Court of Appeal reversed the decision of the High Court and held that the BBEA was only intended to facilitate the proving of banking transactions through the admission of bankers' evidence. The legislative intent of the BBEA was to discard the need for bankers to give formal evidence of bankers' books entries and therefore, the BBEA could not be used as a means to bypass an application for discovery under the ROC.

The Court of Appeal's Decision

The Court of Appeal reversed the decision of the High Court and held that the BBEA was only intended to facilitate the proving of banking transactions through the admission of bankers' evidence. The legislative intent of the BBEA was to discard the need for bankers to give formal evidence of bankers' books entries and therefore, the BBEA could not be used as a means to bypass an application for discovery under the ROC. It also held that such an application for discovery was a pre-requisite to an application under the BBEA which required formal evidence to be adduced by a banker.

The Court of Appeal further decided that copies of entries in banker's books could only be admitted into evidence provided that the requirements of proof set out in the BBEA were satisfied and the High Court judge had failed to identify which of the documents were or were not 'bankers' books'.

The Court of Appeal opined that the following documents were not 'bankers' books' as they did not permanently record transactions in the ordinary business of a bank:

(a) Company documents, memorandum or resolution for opening of bank account, memorandum or resolution for change of authorised signatory;

(b) Miscellaneous internal documents used by the bank including the remittance application form, account opening application form, correspondences and documents on closing of an account;

(c) Cheques and paying-in slips such as cheque deposit receipts and transaction slips; and

(d) Bank statements as these are created for customers' reference only.

Questions Of Law Before The Federal Court

Upon obtaining leave, Protasco appealed against the decision of the Court of Appeal to the Federal Court on the following questions of law:

(1) Whether Section 7 of the BBEA empowers the court to provide orders for discovery independently of Order 24 of the ROC.

(2) Whether the definition of 'banker's book' in Section 2 of the BBEA is to be construed by taking into account current practices in the ordinary business of a bank.

The Federal Court's Decision

At the outset, it is important to state that the Federal Court by majority, set aside the Court of Appeal's decision and affirmed the decision of the High Court. For the purposes of this article, only the majority judgment will be discussed and further analysed herein.

1st Question

In determining the first question, the Federal Court explored the historical origins of the BBEA back when it was legislated in 1949. The BBEA was modelled on the United Kingdom's Bankers' Books Evidence Act 1876 which was re-enacted in 1879 and further amended in 1979. The primary purpose behind the enactment of the BBEA was to overcome the difficulty and hardship associated with producing bankers' books.

Originally, where such bankers' books were required to be produced as evidence, the banker or his clerk had to produce them at the trial under a *subpoena duces tecum* which is a subpoena for the production of evidence. This was an inconvenience to financial institutions when the books were in regular use. Hence, the leading object of the BBEA was to relieve bankers from such inconvenience and to allow for pre-trial disclosure of documentary evidence relating to accounts held by parties to the litigation that were in the hands of the banks.

The Federal Court agreed with Protasco's contention that there are legislations similar to the BBEA and Order 24 Rule 7A of the ROC which were found to co-exist in various foreign jurisdictions such as the United Kingdom, Ireland, Hong Kong and Singapore. In such jurisdictions, the courts have consistently allowed applications to inspect and make copies of banking documents under provisions similar to the BBEA in spite of existing legislation similar to Order 24 Rule 7A of the ROC. Further, as the BBEA was essentially adopted from Section 7 of the Bankers' Books Evidence Act 1879 in the United Kingdom, the Federal Court found that the historical context of the BBEA ought to be taken into account in its interpretation.

Protasco submitted that Order 24 Rule 7A of the ROC, being subsidiary legislation, ought to yield to the BBEA and made reference to Section 130(3) of the Evidence Act 1950 which provides that *"No bank shall be compelled to produce its books in any legal proceeding to which it is not a party, except as provided by the law of evidence relating to banker's books."*

Protasco's two former directors, i.e. the Respondents in this case argued, amongst others, that Section 7 of the BBEA ought to be construed in line with Section 133(1) of the FSA. Section 133(1) of the FSA expressly prohibits the disclosure of any document or information relating to the affairs or account of any customer of a financial institution and any such disclosure amounts to an offence under Section 133(4) of the FSA. On that premise, the Respondents submitted that Section 7 of the BBEA should not be construed as an alternative method or tool for discovery to that found under the ROC.

The Federal Court, however, was not convinced by the Respondents' arguments and decided that the principle of *generalia specialibus non derogent* applied given the co-existence of the two provisions (i.e. Section 7 of the BBEA and Order 24 Rule 7A ROC) on an identical subject matter. As such, the BBEA should be the law to govern bankers' books as opposed to the general provisions of the ROC.

Whilst the Federal Court recognised that the provisions of the FSA coupled with Section 130(3) of the Evidence Act 1950 acts as a safeguard against the disclosure of a person's banking transactions or details which is of utmost importance by virtue of the FSA, the Federal Court opined that the BBEA was an exception to that prohibition against disclosure as it was enacted to specifically deal with banking documents and especially to make adducing evidence in trial more convenient for bankers and their customers. In this regard, the Federal Court agreed with the High Court's finding that the banking documents sought under Section 7 of the BBEA were still subject to the requirements of relevancy which remains the cornerstone of the law of evidence as established in caselaw such as ***Goh Hooi Yin v Teong Ghee & Ors* [1977] 2 MLJ 26** and ***Pean Kar Fu v Malayan Banking Bhd (Toh Boon Pin, intervener)* [2004] 5 MLJ 519.** In this present case, the Federal Court had found that the disputed documents were indeed relevant to prove or disprove the money trail to the Respondents.

As a conclusion, by adopting a purposive approach to the interpretation of the BBEA, the Federal Court answered the first leave question in the affirmative.

2nd Question

The 2nd question was in relation to the definition of 'banker's book'. The documents sought by Protasco as bankers' books under Section 6 and/or Section 7 of the BBEA were entries in the specific bank accounts of the Respondents from the relevant banks and the specific period of the relevant transactions.

According to Section 2 of the BBEA, banker's books is defined to include *"any ledger, daybook, cash book, account book and any other book, used in the ordinary business of a bank."*

In interpreting the said section, the Federal Court considered the provisions of the Evidence Act 1950, in particular, Section 90A which states as follows:

> ***"Section 90A: Admissibility of documents produced by computers, and of statements contained therein***
>
> *(1) In any criminal or civil proceeding a document produced by a computer, or a statement contained in such document, shall be admissible as evidence of any fact stated therein if the document was produced by the computer in the course of its ordinary use, whether or not the person tendering the same is the maker of such document or statement.*
>
> *(2) For the purposes of this section it may be proved that a document was produced by a computer in the course of its ordinary use by tendering to the court a certificate signed by a person who either before or after the production of the document by the computer is responsible for the management of the operation of that computer, or for the conduct of the activities for which that computer was used."*

The FSA gives 'books' the same meaning as that of Section 4(1) of the Companies Act 1965 and Section 2 of the Companies Act 2016 which is:

> *"any register or other record of information and any accounts or accounting records, however compiled, recorded or stored, and also include any document."*

On this issue, the Federal Court considered the decision of ***Barker v Wilson* [1980] 1 WLR 884** where it was held that the definition of 'banker's books' and the phrase 'entry in a banker's book' clearly include *'any form of permanent record kept by the bank of transactions relating to the bank's business, made by any of the methods which modern technology makes available, including, in particular, microfilm.'* In its consideration, the Federal Court also noted that ***Barker v Wilson*** was cited with approval by the Singapore Court of Appeal in ***Wee Soon Kim Anthony v UBS AG* [2003] 5 LRC 171**, where it was held that a purposive approach ought to be taken in interpreting 'banker's book' and in doing so, the changes effected in the practices of bankers are to be recognised.

Following the purposive approach taken in the above cases, the Federal Court agreed that *'banker's books'* and *'entry in a banker's books'* would be any form of permanent record maintained by a bank in relation to the transaction of a customer. This includes correspondence between a bank and a customer which records a transaction given that it would form an integral part of the account of that customer. However, it would not include notes taken by a bank officer of meetings with a customer.

It was also pronounced that with the advent of technology, computerised versions of 'bankers' books' or documents produced or kept by the bank in accordance with advancements in technology such as computers and other forms of information technology are admissible as evidence. This approach to statutory interpretation was called the 'updating' approach which allowed courts to consider or take into account new factors and developments in society after a piece of legislation has been enacted.

Though the Federal Court conceded that a purposive and updating approach ought to be taken when interpreting the term 'banker's book' under the BBEA, the meaning of 'any other book, used in the ordinary course of a bank' should be confined to books of the same kind as 'ledgers, day book, cash book and account book'. Hence, it could not include just any document in the bank's possession. Nonetheless, the Federal Court affirmed the position taken in ***Wee Soon Kim***'s case above that recorded transactions between the customer and the bank qualify as records or entries kept in its 'ledger, day book, cash book and account book'.

Hence, the Federal Court answered the 2nd leave question in the affirmative and concurred with the decision of the High Court in admitting documents under the BBEA which was two-fold:

(1) Firstly, it must be determined whether the documents sought to be admitted within the definition of 'banker's books' is within the ambit of the BBEA.

(2) If a document does not come within the said definition, the document can be admitted subject to the fulfilment of the legal requirements of proof and relevancy under the Evidence Act 1950.

Conclusion

This recent case is a clear indication of the current trend taken by courts towards adopting not only a purposive but an updating approach to statutory interpretation.

As the world continues to progress in light of new technological advancements, courts have recognized that the law, being a living instrument, has to adapt to accord to modern times and new social norms. Given that circumstances have changed significantly since the enactment of legislations such as the BBEA and the FSA, it would be unreasonable to assume that Parliament would have intended for the law to remain static since the enactment of such legislations.

As such, while the FSA is enacted to uphold the secrecy afforded to information including documents in the possession of financial institutions, the courts have evidently recognised that the extent of this duty to secrecy is subject to other legal provisions such as the BBEA after taking into account the purpose of the enactment of the latter legislations.

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"WITH GREAT POWER COMES GREAT RESPONSIBILITY": DUTIES AND RESPONSIBILITIES OF A DIRECTOR

by Diane Ngu

Pursuant to Section 2 of the Companies Act 2016 (CA 2016), a "*Director*" is broadly defined as any of the following:

(a) Any person occupying the position of director of a corporation by whatever name called and includes a person in accordance with whose directions or instructions the majority of directors of a corporation are accustomed to act.

(b) An alternate or substitute director; and

(c) The chief executive officer, chief financial officer, chief operating officer or any other person primarily responsible for the management of the company.

The CA 2016 clearly places the emphasis on substance over form when it comes to determining the persons who are "Directors" of a company.

Division of powers between the shareholders and directors

More often than not, there will be disputes between the shareholders and directors of the company stemming from, amongst others, disagreements over the direction and development of the company or conflicts of interest (due to a director's interests in another business).

A clear example was illustrated in the Federal Court case of *Tengku Dato' Ibrahim Petra bin Tengku Indra Petra v. Petra Perdana Bhd* [2018] 2 CLJ 641 ("**Petra Perdana Case**"), where it was held that shareholders in a general meeting cannot usurp the powers of management conferred by the articles of association of the company on the board of directors, and may only assert their powers over the board of directors by altering the articles of association to take away the powers of the directors whose actions they disapprove or remove the directors concerned in accordance with the then Companies Act 1965 ("CA 1965"). In the Petra Perdana Case, the shareholders in Petra Perdana Bhd mandated the board of directors to divest up to 10% of the company's shareholding in a subsidiary, but the subsequent divestment that was undertaken by the board of directors exceeded such mandate.

The Federal Court took note of Section 131B of the CA 1965, which expressly provides that "*the business and affairs of a company must be managed by, or under the direction of, the board of directors*", highlighting the legislative recognition that the board of directors is the principal management organ of a company, whereby a company's power of management is reserved to its directors and not its shareholders. It should be noted that Section 131B of the CA 1965 has now been replaced with Section 211 of the CA 2016.

The Federal Court also restated the English common law position (which was codified in Section 131B of the CA 1965 and now in Section 211 of the CA 2016) that the board of directors possess the ultimate powers to make business decisions for the company.

The Federal Court also restated the English common law position (which was codified in Section 131B of the CA 1965 and now in Section 211 of the CA 2016) that the board of directors possess the ultimate powers to make business decisions for the company. In the early case of *Automatic Self-Cleansing Filter Syndicate Co. v. Cuninghame* [1906] 2 Ch. 34, CA, the English Court of Appeal made clear that where powers had been vested in the board of directors by the articles of association, the directors cease to be mere agents of the company and the shareholders in a general meeting could not interfere with their exercise of such powers.

Moving back to the Petra Perdana Case, the Federal Court adopted the consistent approach of the foreign jurisdictions and made the legal position clear in respect of the division of powers between the shareholders and directors in managing the affairs of a company. It follows from the decision in this case that shareholders could not generally interfere with commercial decisions made by the board of directors so long as the board is fully mandated by law as well as the company's constitution in managing the company.

Directors To Act In The Best Interest Of The Company

Directors should be mindful of their statutory duties under the CA 2016, one of which is their fiduciary duty to, at all times, exercise their powers in accordance with the CA 2016 for a proper purpose and in good faith for the best interest of the company. In the case of *Dato' Seri Timor Shah Rafiq v. Nautilus Tug & Towage Sdn Bhd [2017] 1 LNS 579,* the High Court observed that:

> "[36] ***the law vests the duty of management of the company in its directors, which must be discharged with reasonable care and diligence in the best interests of the company...***
>
> *[38] their failures would attract liabilities for infringement of their fiduciary and statutory duties under the common law and the statute.* ***Directors owe a stewardship obligation to the company, and it is thus quite basic that they could be liable for any improper management...***"

Further, in the case of *Zaharen Hj Zakaria v. Redmax Sdn Bhd & Other Appeals [2016] 7 CLJ 380*, the Court of Appeal held inter alia as follows:-

> *"[46]* ***Suffice to state here that the baseline threshold must be to see whether the director's impugned conduct has the effect of bringing about adverse and detrimental effects against the interests and wellbeing of the company. It is akin to duty thrust upon a trustee...****"*

> *"****...a director of a company has to give his all to serve in the best interest of the company of which he is a director. As a fiduciary, the company is backed up by the statutory provision to expect nothing less from its directors****. Gone are the days when a company director can be heard to say that he was a sleeping director and expect to escape liability. His duty may appear to be onerous but that is to be expected as he is part of the alter ego of the company.* ***He is a fiduciary, a trustee. It is not his business to act like a rogue, much less to act to the detriment of the company...****"*

It can be seen from the cases above that the courts have provided certain guidelines and interpretation on a director's fiduciary duties. However, the courts have not adopted a checkbox approach in determining whether a director has acted in the best interest of the company.

It is also worth noting from the Petra Perdana Case where the Federal Court rejected the Court of Appeal's reliance on the test from the case of *Paidiah Genganaidu v. The Lower Perak Syndicate Sdn Bhd & Ors* [1973] 1 LNS 105 FC ("**Paidiah Case**") in determining whether the directors acted in the best interest of the company. In the Paidiah Case, it was held that "*what is beneficial to the company as a whole is usually a matter for the shareholders to decide*". It was then assumed by the Court of Appeal in the Petra Perdana Case that in determining whether the directors acted in the best interest of the company, courts must have regard as to whether the directors had taken into consideration the shareholders' resolution, which provided a barometer as to the shareholders' view as the best interest of the company.

Instead, the Federal Court took the view that the test in the Paidiah Case was to be applied in the context of its specific facts, whereby the views of the majority might be taken to represent what was best for the company only under such circumstance where there was difference of opinion between the shareholders themselves. Accordingly, the Federal Court held that this test was not to be applied with a one-size-fits-all approach for subsequent cases in deciding whether a director acted in the best interest of a company.

The Federal Court went on to set out the correct test for the breach of director's duty to act in the best interest of the company, which combines both subjective and objective tests as follows:

- **Subjective test**: The court has to assess whether a director had exercised his discretion

bona fide in what he considered (and not what the court considers) is in the interests of the company (Re Smith & Fawcett Ltd [1942] Ch 304); and

- **Objective test:** The court has to assess whether an intelligent and honest man in the position of a director of the company concerned could, in the whole of the existing circumstances, have reasonably believed that the transactions were for the benefit of the company (Charterbridge Corporation Ltd v. Lloyds Bank Ltd [1970] 1 Ch 62).

Directors To Exercise Reasonable Care, Skill And Diligence

Section 213(2) of the CA 2016 states that a director of a company must exercise reasonable care, skill and diligence. This duty imposes an objective test based on the '*knowledge, skill and experience which may reasonably be expected of a director having the same responsibilities*' and the degree of care required is the standard of care which a person with similar responsibilities would exercise on his own behalf. This duty also imposes a more subjective test based on '*any additional knowledge, skill and experience which the director in fact has*', which effectively imposes a higher standard expected of a director who possesses more relevant skill and experience.

The statutory business judgment rule provides a presumption that a director acted with due care and skill if the abovementioned requisite pre-conditions are fulfilled. These pre-conditions are premised on the courts' reluctance to substitute its own decision with the business and management decisions of the directors.

This was also expounded by the Singapore High Court in *Vita Health Laboratories Pte Ltd and others v. Pang Seng Meng* [2004] 4 SLR (R) 162, which upheld the rule that a court will not substitute their own judgment for that of directors, especially with the benefit of hindsight. In emphasising that the court had to be slow to interfere with bona fide commercial decisions taken by directors, the High Court stated:

"This judicial endorsement of the sanctity of business judgment is underpinned by strong policy considerations. ***It is the role of the marketplace and not the function of the court to punish and censure directors who have in good faith, made incorrect commercial decisions.*** *Directors should not be coerced into exercising defensive commercial judgment, motivated largely by anxiety over legal accountability and consequences.* ***Bona fide entrepreneurs and honest commercial men should not fear that business failure entails legal liability.*** *A company provides a vehicle for limited liability and facilitates the assumption and distribution of commercial risk.* ***Undue legal interference will dampen, if not stifle, the appetite for commercial risk and entrepreneurship****."*

As such, the courts do not usually assess the merits of or interfere with commercial decisions or business judgment made by directors, as such interference may not sit well with the commercial realities of inevitable risk-taking for profits. It is the duty of court to review such commercial decisions only in cases where fraud, breach of fiduciary duty and conspiracy are established.

It is also worth noting that a breach of any statutory duties of a director under Section 213 of the CA 2016 may result in imprisonment for a term up to 5 years or to a hefty fine not exceeding RM3 million or both.

Reliance On Information Provided By Others

As making business decisions is often not a straightforward affair with many aspects to be considered, a director in exercising his duties may rely on information, professional or expert advice, opinions, reports or statements including financial statements and other financial data, prepared, presented or made by:

(a) Any officer of the company whom the director believes on reasonable grounds to be reliable and competent on the matters concerned.

(b) As to matters involving skills or expertise, any other

person retained by the company in relation to matters that the director believes on reasonable grounds to be within the person's professional or expert competence.

(c) Another director in relation to matters within the director's authority.

(d) Any committee to the board of directors on which the director did not serve in relation to matters within the committee's authority.

However, directors should remain cautious in relying on information provided by others, as such reliance is only deemed reasonable if it was made:

(a) In good faith; and

(b) After making an independent assessment of the information or advice, opinions, reports or statements, including financial statements and other financial data, having regard to the director's knowledge of the company and the complexity of the structure and operation of the company.

Enhanced Director Duties Under The Financial Services Act 2013

The Financial Services Act 2013 (FSA), which came into force on 30 June 2013, sets out the regulatory framework for the financial institutions, payment systems and other relevant entities in Malaysia. The FSA contains provisions that enable Bank Negara Malaysia (BNM) to meet the objectives of a central bank by empowering it to regulate and supervise the financial system in Malaysia. The FSA also provides for enhanced director duties and liabilities for institutions, namely authorized persons or operators of designated payment systems under the FSA.
In addition to the general duties of directors under the CA 2016, the board of directors under the FSA is specifically responsible for:

(a) Setting and overseeing the implementation of business and risk objectives and strategies and in doing so to have regard to the long-term viability of the institution and reasonable standards of fair dealing.

(b) Ensuring and overseeing the effective design and implementation of sound internal controls, compliance and risk management systems commensurate with the nature, scale and complexity of the business and structure of the institution.

(c) Overseeing the performance of the senior management in managing the business and affairs of the institution.

(d) Ensuring that there is a reliable and transparent financial reporting process within the institution; and

(e) Promoting timely and effective communications between the institution and BNM on matters affecting or that may affect the safety and soundness of the institution.

In carrying out the functions or duties of directors under the FSA, the board of directors of an institution shall have regard to the interests of depositors or policy owners of the institution and participants.

The duties of directors as set out under the CA 2016 are also reproduced under the FSA, including to act in good faith in the best interests of the institution, to exercise reasonable care, skill and diligence, to only exercise powers conferred on them for the purposes for which such powers are conferred and to exercise sound and independent judgement. It should be noted that these duties under the FSA complement and do not derogate from the duties of directors under the CA 2016. It is a serious offence under the FSA for a director of an institution to act beyond his legal power or authority, and if convicted, such director will be liable to imprisonment for a term not exceeding 8 years or to a fine not exceeding RM25 million or both.

Further, a director of an institution must disclose to the board of directors the nature and extent of his direct or indirect interest in a material transaction or arrangement with the institution and should not be present at the board meeting where such transaction or arrangement is being deliberated. Any subsequent changes in the nature and extent of such interest must also be promptly disclosed to the board. In this regard, BNM is given the discretion to determine what constitutes a material transaction or material arrangement, as well as the time, manner and form in which the aforementioned disclosure is to be made.

FSA also sets out the minimum requirements to be appointed as a chairman, director, chief executive officer or senior officer of an institution and gives BNM discretion to specify the fit and proper requirements to be complied with by such persons. This may include certain minimum criteria in relation to the person's personal and financial integrity, reputation as well as competency.

As such, directors are expected to play a more proactive role and address their minds to all compliance matters instead of merely relying on their legal and compliance officers. This includes ensuring a robust scrutiny on all compliance matters of the institution and keeping proper minutes of all board deliberations. It pays for directors to be meticulous and prudent because under the FSA, a director will be deemed guilty of an offence committed by his company or its employees unless he proves that the offence was committed without his consent or connivance and that he has exercised such diligence to prevent the commission of the offence as he ought to have exercised, having regard to the nature of his function in that capacity and to the circumstances.

Malaysian Code On Corporate Governance (MCCG)

The MCCG issued by the Securities Commission Malaysia is a set of corporate governance best practices for companies to adopt. Pursuant to Principle A, "*Board Leadership and Effectiveness*", the board of directors are collectively responsible for the long-term success of a company and the delivery of sustainable value to its stakeholders by governing and setting the strategic direction of the company while exercising oversight on management and is expected to discharge its fiduciary duties and leadership functions in the interests of the company at all times.

In respect of Principle C, "*Integrity in Corporate Reporting and Meaning Relationship with Stakeholders*", the board of directors needs to ensure that there is effective, transparent and regular communication with its stakeholders to provide stakeholders a better appreciation of the company's objectives and the quality of its management, which will in turn assist stakeholders in evaluating the company and facilitate shareholders to determine how their votes should be exercised.

The MCCG also recognizes that general meetings are important platforms for directors and senior management to engage with shareholders to facilitate a greater understanding of the company's business, governance and performance, which supports

shareholders in exercising their ownership rights and expressing their views to the board and senior management on any areas of concerns. The MCCG encourages shareholders to exercise their rights to ask questions, provide views and vote at general meetings.

This recommendation under the MCCG strikes an optimum balance between upholding the clear division of powers among the shareholders and the directors as unequivocally established in law and providing an appropriate avenue to facilitate a transparent dialogue between the directors and shareholders for the best interest of the company.

The bottom line is that the appointed directors of a company are accountable to the shareholders. In that regard, directors should always bear in mind that notwithstanding their discretion in making the overall business decisions of a company, shareholders have the power to alter or amend the company's constitution by way of a special resolution to remove such directors' powers, whereby actions or decisions by the directors thereafter would be *ultra vires* if they are not exercised in accordance with the CA 2016 and the constitution. Shareholders could also remove the directors or otherwise refuse to re-elect the directors whose actions they disapprove.

Conclusion

Although under common law, directors are given the prerogative to drive the day-to-day business operations of a company independent of the shareholders' influence, this does not amount to unfettered discretion on the directors' part as such prerogative is underpinned with fiduciary duties and obligations towards the company. As the saying goes, "with great power comes great responsibility" – it pays to be a director when a company is successful but there may also be a price to pay under the law if the abovementioned directors' duties are not duly observed.

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LICENSING OF DIGITAL BANKS: REGULATORY COMPLIANCE AND DATA PROTECTION CONSIDERATIONS

by Shera Chuah

In line with the 5 strategic thrusts outlined in the Financial Sector Blueprint 2022-2026 launched by the Bank Negara Malaysia (BNM), BNM had on 29 April 2022 announced 3 successful applicants for the conventional digital banking licence under the Financial Services Act 2013 (FSA 2013) and 2 successful applicants for the Islamic digital banking licence under the Islamic Financial Services Act 2013 (IFSA 2013).

Following the award of digital banking licences, successful applicants will undergo a period of operational readiness that will be validated by BNM through an audit before they can commence operations. The process may take between 12 to 24 months.

This legal insight discusses the regulatory regime applicable to digital banks in Malaysia when their operations commence and highlights several data protection considerations relating thereto.

What Is A Digital Bank?

Digital banks are banks which carry on banking business wholly or primarily through digital or electronic means. By way of illustration, Monzo and Starling Bank are digital banks in Europe which were launched before the outbreak of the COVID-19. It is envisaged that such development in the financial services sector in Malaysia would add dynamism to the banking landscape and foster financial inclusion of the unserved and underserved populations.

Regulatory Framework

- **Foundational Phase**

For a minimum period of 3 years and up to a maximum period of 5 years after the commencement of operations (Foundational Phase), a licensed digital bank will be

subject to regulatory requirements applicable to an existing licensed bank or licensed Islamic bank (including requirements relating to consumer protection and anti-money laundering/countering financing of terrorism), except for several simplified regulatory requirements as set forth in the Licensing Framework for Digital Banks issued by the BNM on 31 December 2020. The purpose of such Foundational Phase is for the licensed banks to demonstrate their viability and sound operations, and for BNM to observe the performance of the licensed digital banks and attendant risks that arise from their operations.

The areas of simplification or exemption to the existing regulatory framework applicable to licensed digital banks during the Foundational Phase are as follows:

(1) Asset limit and business limitation

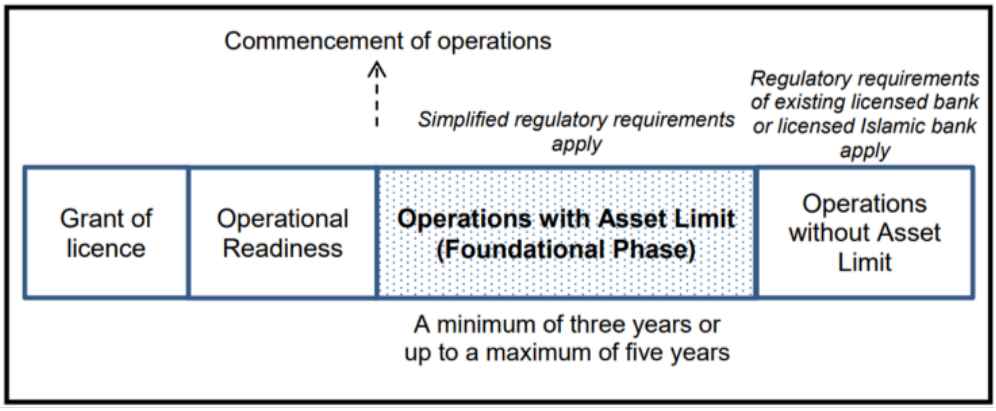
A licensed digital bank is required to –

(a) Maintain at all times a minimum amount of capital funds of RM100 million unimpaired by losses.

(b) Maintain a minimum total capital ratio of 8%; and

(c) Ensure that its total size of assets do not at all times exceed the limit of RM3 billion.

An overview of the timeline of the operational progression of the licensed digital bank is illustrated below.



(2) Liquidity

Further, a licensed digital bank shall hold an adequate stock of unencumbered Level 1 and Level 2A high-quality liquid assets (HQLA) equivalent to at least 25% of its total on-balance sheet liabilities. The definitions of Level 1 and Level 2A assets are provided for in the policy document on Liquidity Coverage Ratio and include *inter alia*:

(a) Level 1 assets: cash, term deposit placements, and marketable securities representing claims explicitly guaranteed by sovereigns or multilateral development banks that satisfy the requirements set out in the policy document on Liquidity Coverage Ratio.

(b) Level 2A assets: marketable debt securities, including commercial papers issued by Cagamas Berhad which have been assigned a rating of AAA/P1 by recognised external credit assessment institutions or are internally rated as having a probability of default corresponding to a credit rating of AAA.

(3) Stress testing

A licensed digital bank shall be exempted from the requirements under the policy document on Stress Testing.

A licensed digital bank shall be exempted from the requirements under the policy documents on Risk Weighted Capital Adequacy Framework (Basel II) – Disclosure Requirements (Pillar 3) and the policy document on Capital Adequacy Framework for Islamic Banks (CAFIB) – Disclosure Requirements (Pillar 3).

(4) Public Disclosures

A licensed digital bank shall be exempted from the requirements under the policy documents on Risk Weighted Capital Adequacy Framework (Basel II) – Disclosure Requirements (Pillar 3) and the policy document on Capital Adequacy Framework for Islamic Banks (CAFIB) – Disclosure Requirements (Pillar 3).

However, the following information shall be included as part of the explanatory notes in the financial statements of a licensed digital bank–

(a) breakdown of gross risk-weighted assets for each risk component; and

(b) for credit risk-weighted assets, the breakdown of the various categories of risk weights.

(5) Shariah Governance

In respect of licensed digital bank carrying on Islamic digital banking business, all requirements in the policy document on Shariah Governance shall apply, except for the following –

(a) The Shariah Committee must comprise at least 3 members; and

(b) The Shariah Committee must convene at least 2 times a year.

• **Post Foundational Phase**

Notably, licensed digital bank may after 3 years from the commencement of its operations, submit an application to the Bank to put an end to the Foundational Phase.

In any event, by the end of the 5th year from the commencement of its operation, a licensed digital bank shall at all times comply with the existing legislative and supervisory framework applicable to an existing licensed bank or licensed Islamic bank, such as the provisions in the FSA 2013 and the IFSA 2013 (as the case may be) and other rules, standards and regulations issued by the BNM from time to time. The exemption and relaxation of regulatory requirements as discussed above would no longer be applicable.

Personal Data Protection Considerations

As consumers engage and purchase banking services and products offered by digital banks, a vast amount of personal information would be collected and processed.

Digital banks being the "data user" must abide by the 7 overarching principles set out in the Personal Data Protection Act 2010 (PDPA 2010) and the relevant regulations in the course of providing digital banking services, namely the General Principle, the Notice and Choice Principle, the Disclosure Principle, the Security Principle, the Retention Principle, the Data Integrity Principle and the Access Principle.

Therefore, digital banks being the "data user" must abide by the 7 overarching principles set out in the Personal Data Protection Act 2010 (PDPA 2010) and the relevant regulations in the course of providing digital banking services, namely the General Principle, the Notice and Choice Principle, the Disclosure Principle, the Security Principle, the Retention Principle, the Data Integrity Principle and the Access Principle. A data user who fails to adhere to these principles commits an offence and upon conviction, is punishable with a fine not exceeding RM300,000 or imprisonment for a term not exceeding 2 years or both.

Further, digital banks should also comply with the Personal Data Protection Code of Practice for the Banking and Financial Sector (Code of Practice). The Code of Practice provides for specific standards of conduct in respect of personal data that are in the possession or under the control of data of licensed banks under the FSA 2013 and licensed Islamic banks under the IFSA 2013. Non-compliance with the Code of Practice would attract criminal sanctions by virtue of Section 29 of the PDPA 2010.

While convenience and efficiency may attract consumers, the key to bolster long term consumer confidence hinges on data security. It is crucial that digital banks offer the highest level of data security to safeguard consumer's personal data and financial

information from any cyber fraud. In addition to adhering to the PDPA 2010 and the Code of Practice, it would be prudent for licensed digital banks to take extra precautionary steps by integrating strong privacy controls into their data storage systems and by putting in place a robust cybersecurity governance framework to mitigate and manage any cybersecurity risks.

Conclusion

The new entrants in the digital banking sector would be expected to transform our financial ecosystem and create a conducive banking environment for the enablement of technology-based innovations and for the benefit of Malaysian consumers. While Malaysia embarks on this journey to materialise such digital transformation, a whole new wave of digital products and solutions would be required, with the support of a robust regulatory ecosystem, innovative technology and cultural adaptation which will then stimulate national economic growth and financial inclusion.

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BUYING AUCTIONED PROPERTY – DOES THAT GIVE RISE TO A PRIVATE CONTRACT WITH THE CHARGEE BANK?

by Stephanie Chong Keh Yin

In *Ambank (M) Bhd v AIM Edition Sdn Bhd* [2022] 1 MLJ 357, the Federal Court decided that a successful bidder shall have no cause of action for breach of contract against the chargee bank for loss suffered as a result of a purported shortfall in the size of the land that was purchased in a public auction.

Brief Facts

AIM was the successful bidder of the subject land in a public auction and is now the registered owner after completion of the purchase. The public auction was initiated by Ambank, who was the chargee bank. Prior to the public auction, SAP Holdings Berhad was the original registered owner of the subject land in 94.76 hectares. The land area was also stated as 94.76 hectares in the Proclamation of Sale.

Subsequent to the purchase, AIM discovered through its surveys that about 12.7655 hectares overlapped with 5 other lots (appeared as a result of encroachment) where 4 separate titles have been issued and 1 future title was in the process of being issued. In other words, AIM only owns 81.9945 hectares of the land as opposed to the entirety of 94.76 hectares stated in the Proclamation of Sale published by Ambank. As such, AIM commenced action in the High Court against Ambank for breach of contract as it had not received the entirety of 94.76 hectares of the subject land. The main issue before the High Court, Court of Appeal and Federal Court was whether there was a concluded contract between AIM and Ambank.

AIM took the position that there was a concluded contract between Ambank and itself following the successful bid in the public auction. It was AIM's position that the Proclamation of Sale, the Memorandum and Terms of Sale, as well as the Borang 16F collectively constituted a contract between AIM and Ambank. Since the Proclamation of Sale published by Ambank stated the land area in 94.76 hectares, Ambank was in breach of contract when the actual land size owned by AIM was 12.7655 hectares lesser than the 94.76 hectares as advertised.

Meanwhile, Ambank took the position that there was no concluded contract because it was not the owner of the subject land, and therefore it could not be the vendor in the sale of the subject land in the public auction. Ambank took the position that the subject land was sold by the Registrar vide order of the court.

High Court's Decision

The High Court dismissed AIM's claim on the primary basis that there was no concluded contract between AIM and Ambank. It was held that the sale *vide* the public auction is a judicial sale wherein Ambank is only exercising its statutory right under the National Land Code as a chargee bank in the event of a default of the chargor. In such sale, the chargee bank could not be regarded as a vendor of the subject land/property. For completeness, the High Court held:

> *"[37] The sale in this case of the subject property is indisputably a judicial sale pursuant to an order for sale ('OFS') made by the High Court under the National Land Code ('the NLC'). In obtaining the OFS, the defendants/chargee bank was exercising its statutory rights under the NLC.*
>
> *[38] It is settled law that in a judicial sale by public auction, the chargee bank in exercising its statutory rights is not regarded as the vendor in the sale. Hence, there is no relationship of vendor and purchaser between P and D in this case. It follows that there was, therefore, no contractual relationship between the parties in respect of the subject property. The vendor would be the High Court which carried out the sale through the registrar."*

Apart from that, the High Court further found that the particulars of the land title were at all times accurate and were not disputed. It appears that the High Court considered that the land area stated as 94.76 hectares in the Proclamation of Sale was provisional because it was held that *"the POS make no representation as to the size of the land per se but merely sets out the particulars of the title".*

Court Of Appeal's Decision

The Court of Appeal reversed the High Court's decision. In essence, the Court of Appeal held that there was a concluded contract between AIM and Ambank, wherein the chargee bank is to be regarded as the vendor and the successful bidder as the purchaser. The Court of Appeal found support from High Court's decision in *Malayan United Finance Bhd Johore Bahru v Liew Yet Lan* [1990] 1 MLJ 317, wherein it was held that *"in as much as the chargee at whose instance the sale is effected is to be regarded as the vendor, the order for sale and the said conditions of sale are to be regarded as the sale and purchase agreement*". This position was reaffirmed by the Court of Appeal in *Santhi A/P Krishnan v Malaysia Building Society Berhad* [2015] MLJU 2116.

The Court of Appeal further held that the term in the Proclamation of Sale stating that the land area was 94.76 was an express term and thus "*was specifically agreed on between the parties when they entered into the contract*". It was the Court of Appeal's decision that Ambank had breached the purported contract in not delivering the entirety of 94.76 hectares of the subject land. The court also added that Section 269(3) of the National Land Code does not exempt a chargee from liability for compensation for the losses arising from any judicial sale by public auction.

Federal Court's Decision

In the Federal Court, AIM obtained leave to appeal based on the following leave questions:

(a) Whether a judicial sale pursuant to Section 257 of the National Land Code gives rise to a contract between the chargee bank and a successful bidder.

(b) Whether the conditions of sale, including the proclamation of sale in particular cl 23 of conditions of sale pursuant to a judicial sale under Section 258 of the National Land Code which are formulated by the Chief Registrar of the High Court of Malaya and which have to be strictly adhered to, is contrary to Section 29 of the Contracts Act 1950.

(c) Whether in establishing and proving damages, no valuation of the actual land identified as being 'excluded' is necessary or can a plaintiff establish quantum of damages by mere mathematical deduction of acreage.

In gist, the Federal Court answered the 1st question in the negative and decided that the remaining 2 questions do not warrant any answer as they simply do not arise.

The Federal Court held that there is no concluded contract between AIM and Ambank because a sale vide a public auction was a *"judicial sale of the subject property, judicial as it is ordered by the court after the court is satisfied that the grounds for ordering a sale under the National Land Code have been met"*. The Federal Court further held:

> *"[40] The judicial sale of the property which is subject of the charge was sought for by the chargee bank who was merely enforcing its statutory rights as a chargee when the chargor defaulted or was in breach of the underlying contract between them. Such statutory rights which are available under s 256 of the National Land Code read with O 83 of the Rules of Court 2012 are mandatory and not permissive — see Kimlin Housing Development Sdn Bhd (appointed receiver and manager) (in liquidation) v Bank Bumiputra (M) Bhd & Ors [1997] 2 MLJ 805. In pursuing those rights, the chargee does not displace the chargor as the owner of the property concerned. At all times, the chargor remains the owner."*

The Federal Court found support from the Supreme Court's decision in *M & J Frozen Food Sdn Bhd & Anor v Siland Sdn Bhd & Anor* [1994] 1 MLJ 294 where it was held that a sale under Section 256 of the National Land Code does not contemplate that the chargor renounces or surrenders all his proprietory rights in favour of the chargee, neither do the law contemplate any transfer of such proprietary rights from the chargor to the chargee. In this regard, the chargee bank cannot be regarded as the vendor of the subject property and therefore, the chargee bank is not in the capacity to enter into a contract with the successful bidder.

Suffice to note from the Federal Court's decision that the right of the chargee bank to enforce a sale in the event of a default of the chargor is a statutory right provided under Section 256 of the National Land Code read together with Order 83 of the Rules of Court 2012.

In short, the Federal Court allowed Ambank's appeal and reinstated the decision of the High Court.

Commentary

Suffice to note from the Federal Court's decision that the right of the chargee bank to enforce a sale in the event of a default of the chargor is a statutory right provided under Section 256 of the National Land Code read together with Order 83 of the Rules of Court 2012. These provisions are provided to secure the interest of a chargee bank, and the chargor may only oppose to the grant of an order for sale in the event of the existence of a "*cause to the contrary*". According to *Low Lee Lian v Ban Hin Lee Bank Bhd* [1997] 1 MLJ 77, a cause to the contrary within Section 256(3) of the National Land Code may be established only in 3 categories of cases, which includes:

(i) When a chargor was able to bring his case within any of the exceptions to the indefeasibility doctrine in Section 340 of the National Land Code.

(ii) When a chargor could demonstrate that the chargee had failed to meet the conditions precedent for the making of an application for an order for sale.

(iii) When a chargor could demonstrate that the grant of an order for sale would be contrary to some rule of law or equity. If no cause to the contrary could be shown, the court would be obliged to make an order for sale. The right of the chargee bank is undoubtedly well protected under such provision.

Following the decision in *Ambank (M) Bhd v AIM Edition Sdn Bhd* [2022] 1 MLJ 357, the right of the chargee bank is further protected as against a successful bidder in a public auction from the cause of action of breach of contract. The Federal Court's decision highlights that a chargee bank is not the owner of the subject property and thus cannot

AIM's successful bid therefore could not be viewed as an acceptance so as to form a concluded contract between the chargee bank as a vendor and the successful bidder as a purchaser.

be the vendor in a public auction. Whilst the successful bidder in a public auction might have signed a Contract for Public Auction as what AIM did after the acceptance of its bid, it is pertinent to note that the completion of the sale is to be evidenced by a certificate of sale (Form 16F) as opposed to a Sale and Purchase Agreement.

Further, it can be argued that there are no agreed terms between the chargee bank and the successful bidder because the price of the auctioned property is subject to a reserve price to be determined by the court in an application for an order for sale. Most commonly and pursuant to Section 257 of the National Land Code, the reserve price will be fixed around the market price of the subject property to prevent selling of the subject property at an unreasonably low price. In this respect, it could be said that there is no pre-contractual negotiation and therefore no agreed terms between the chargee bank and the successful bidder. Although the Proclamation of Sale is usually advertised by the chargee bank to the public at large, this does not in itself render the public auction a unilateral offer because the chargee bank has no complete control over the selling price of the subject property. AIM's successful bid therefore could not be viewed as an acceptance so as to form a concluded contract between the chargee bank as a vendor and the successful bidder as a purchaser.

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ARE FINANCING COSTS TAX DEDUCTIBLE?

by Kar Ngai Ng

Financing costs are expenses incurred by an entity in connection with the borrowing of funds. Typical financing costs would include interest, legal and professional fees, front-end fees, arrangement fees, facility agent fees, security agent fees, processing fees, stamp duties agency fees, break-funding loss and all other similar, ancillary or incidental expenses incurred on borrowings.

In recent years, as the range of financing options has become increasingly complex, the material costs in relation to such loan facilities have also grown significantly. This has led taxpayers to pay more attention to the question of deductibility of financing costs in the computation of taxable profits.

Generally, the resulting tax treatment of financing costs would depend on whether such expenses are revenue in nature or capital in nature. This is in line with the fundamental principle that only revenue expenditure may be claimed as a deduction. Capital expenditure is not deductible when calculating trading profits.

Tax Treatment Of Interest Expense

"Interest" is not statutorily defined in the Income Tax Act 1967 (**ITA**). In Halsbury's Laws of England, the term "interest" is defined as the return or compensation for the use or retention by a person of a sum of money belonging to or owed to another.

Despite the lack of a statutory definition, Section 33(1)(a) of the ITA specifically provides for the deduction of interest expense. This section prescribes that interest upon money borrowed is deductible if:

(a) The borrowing is employed in the production of gross income; or

(b) The borrowing is laid out on assets used or held for the production of gross income.

Notably, the Federal Court in *Director-General of Inland Revenue v Rakyat Berjaya Sdn Bhd* [1984] 1 MLJ 248 has recognised that interest is inherently a revenue expense, even if the principal debt on which it is paid was incurred to acquire capital assets.

However, if a person has borrowed money for purposes of business as well as for non-business purposes, Section 33(2) of the ITA will restrict the interest expense allowable as a deduction. The deduction of interest expense payable on borrowed money used for purposes of business as well as for non-business purposes is determined as follows:

(a) If the total amount of investments and loans is the same with or exceeds the amount of borrowed money, the whole amount of interest expense is disallowed; or

(b) If the total amount of investments and loans is less than the amount of borrowed money, then only a portion of the interest expense is disallowed.

Tax Treatment Of Other Financing Costs

Unlike interest, the ITA does not contain any provision on the deduction of other financing costs. In light of this, reliance is placed on the general deduction provision of Section 33(1) of the ITA. Section 33(1) is a basket provision which allows taxpayers to deduct expenditure incurred in the course of business.

In order to obtain a deduction under Section 33(1), the following elements must be satisfied:

(a) Outgoings and expenses;

(b) Wholly and exclusively;

(c) Incurred during that period;

(d) In the production of income; and

(e) Not prohibited under Section 39(1).

Wholly And Exclusively

What is wholly and exclusively laid out for the purposes of the trade depends on the facts of each case. In *Robert Addie & Sons' Collieries Ltd v The Commissioners of Inland Revenue* 8 TC 671, the UK court held that this is a question which must be determined upon the principles of ordinary commercial trading. Accordingly, it is necessary to ask the question of whether the expenditure is made for the purpose of earning the profits.

The UK Court of Appeal in *Bentleys, Stokes & Lowless v Beeson* (1952) 2 All ER 82 further had the occasion to examine the meaning of "wholly and exclusively" as the motive or object in the mind of the individual for the activities in question.

These above principles were subsequently applied by our Court of Appeal in *Aspac*

Lubricants Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri [2007] 5 CLJ 353 and the Special Commissioners of Income Tax (**SCIT**) in *ABC Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* (2011) MSTC 10-024.

Production Of Income

The phrase "in the production of income" provides for an evaluation of the closeness or remoteness between an expenditure incurred and the earning of income of the business. However, the test is not strict to the extent that only expenditure directly connected to the earning of income are allowed as a deduction.

Our High Court in *Ketua Pengarah Hasil Dalam Negeri v Servier Malaysia Sdn Bhd* (2012) MSTC 30-038 applied the Australian High Court's decision in *W Nevill & Co Ltd v Federal Commissioner of Taxation* (1937) 56 CLR 290, where it was held that it is necessary, for income tax purposes, to look at a business as a whole set of operations directed towards producing income. In *Director General of Inland Revenue v Kulim Rubber Plantations Ltd* [1981] 1 MLJ 214, our Federal Court examined the phrase as for the purpose of enabling a person to carry on and earn profits in the trade.

Deductibility Of Financing Costs

This issue was recently examined in the case of *XYZ v Ketua Pengarah Hasil Dalam Negeri*, where the taxpayer had challenged the decision of the Director General of Inland Revenue (**DGIR**) to disallow its claim of financing expenses under Section 33(1) of the ITA.

In *XYZ* (supra), the taxpayer is principally involved in investment holding. The taxpayer finances its business activities through, among others, external debt financing. As part of its financing, the taxpayer had acquired a loan which was used to on-lend to its subsidiary, and from which the taxpayer earned interest income. The taxpayer claimed a deduction for the financing expenses incurred in relation to the interest income earned from on-lending the loan.

However, the DGIR disallowed the financing expenses as a deduction under Section 33(1) of the ITA on the basis that such financing expenses are capital in nature. Being aggrieved, the taxpayer filed an appeal to the SCIT. The arguments canvassed before the SCIT include case law from various jurisdictions, which has established that financing expenses are deductible.

Malaysia

In *FCD Sdn Bhd v Ketua Pengarah Jabatan Hasil Dalam Negeri* (1995) 2 MSTC 2181, the SCIT held that the guarantee fees paid by the taxpayer on syndicated loans taken to finance

the taxpayer's property development business are deductible under Section 33(1) being expenses wholly and exclusively incurred in the production of income. The SCIT had found that the nexus linking interest, guarantee fee and commitment fee is so integral to the loan package in that they represent different facets of the loans so crucial and critical to the realisation of the taxpayer's income.

The SCIT also decided that if the interest expense was already acknowledged as wholly and exclusively incurred in producing the income, surely the guarantee fees which not only stand on the same footing with the interest and commitment fee but on a much stronger ground and justification must inevitably come within Section 33(1).

The decision in *FCD* (supra) was subsequently affirmed by the High Court, which held that the SCIT were right in law in coming to their finding that the guarantee fees are deductible from the taxpayer's gross income.

Further, in the recent decision of *KM v Ketua Pengarah Hasil Dalam Negeri*, the SCIT held that borrowing costs in respect of a loan are deductible under Section 33(1). In *KM* (supra), the taxpayer is a public listed company with a plantation business as its principal business. In the course of the taxpayer's business, the taxpayer entered into various financing transactions. The taxpayer incurred borrowing costs such as legal and professional fee, arrangement fee and all other similar expenditure that is incidental and in relation to the loans obtained by the taxpayer. After a full hearing, the SCIT decided that the miscellaneous borrowing costs which were incurred on borrowings obtained by the taxpayer are deductible against the taxpayer's taxable income under Section 33(1). This decision was recently affirmed by the High Court.

Singapore

In the landmark case of *Comptroller of Income Tax v IA* (2007) MSTC 7,549, the Singapore Court of Appeal relied on *FCD* (supra) and ruled that the borrowing expenses incurred by the taxpayer are deductible. The Singapore Court of Appeal held that one must ascertain the purpose of the taxpayer entering into the loan, i.e. whether the loan was for the purpose of revenue or capital. The Singapore Court of Appeal explained that this is determined by establishing whether there is a sufficient linkage or relationship between the loan and the main transaction for which the loan was taken.

The Singapore Court of Appeal summarised the guideline in relation to loans as follows:

(a) First, it is to be ascertained whether or not there is a sufficient relationship or linkage between the loan in question and the main transaction for which the loan has been taken, i.e. whether the loan was taken to finance the main transaction or project. If

there is no linkage or nexus, it must be assumed that the sole purpose of the loan was to augment or add to the capital structure of the taxpayer; and

(b) Next, if there is sufficient linkage or nexus, whether or not the main transaction itself is capital or revenue in nature. If the main transaction is revenue in nature, the loan itself would be revenue in nature as the loan derives its character from the main transaction.

United Kingdom

The House of Lords' decision in *Farmer (Surveyor of Taxes) v Scottish North American Trust, Limited* [1912] AC 118 similarly held that despite the temporary and fluctuating manner in which the money concerned was borrowed, the focus was really on the fact that the purpose of the loans was centred on revenue as opposed to capital purposes.

India

The Indian Supreme Court in the case of *The India Cements Ltd v The Commissioner of Income-tax, Madras* (1966) AIR 1053 SC considered the purpose of the loan for the business of the taxpayer and concluded that the loan is not an asset or advantage. The Indian Supreme Court went on to state that in principle, apart from any statutory provisions, there is no distinction between interest in respect of a loan and expenditure incurred for obtaining the loan. This is because a loan is a liability that has to be repaid and it is erroneous to consider a liability as an asset or an advantage for the enduring benefit of the business of the taxpayer.

In *The Bombay Steam Navigation Co v Commissioner of Income Tax* (1965) AIR 1201 SC, the Indian Supreme Court also held that in determining whether a particular expenditure is revenue expenditure incurred for the purpose of the business, all the facts and circumstances must be considered. The question must be viewed in the larger context of business necessity or expediency. If the outgoing or expenditure is so related to the carrying on or conduct of the business that it may be regarded as an integral part of the profit-earning process and not for the acquisition of an asset or a right of a permanent character, the expenditure may be regarded as revenue expenditure.

The case law above demonstrates that depending on the facts of the case, financing costs incurred in the ordinary course of business could be revenue in nature and hence deductible.

Importance Of Keeping Records And Documents

Having said the above, record keeping is extremely important to be able to support any claim for deduction. This is especially since under the ITA, taxpayers have a statutory obligation to keep records and documents for the purposes of ascertaining their chargeable income and tax payable.

Under Sections 82 and 82A of the ITA, taxpayers are required to keep and retain in safe custody sufficient records and documents for a period of seven years from the end of the year of assessment in which the income tax return form is furnished. During a tax audit, these records and documents are used to support the claim of expenses that have been made in the income tax return form.

It is noted that the DGIR has the authority to request from a taxpayer any information and particulars as may be required by a notice issued pursuant to Section 81 of the ITA. Information and particulars can be obtained either orally or in writing within the specified time. Failure by the taxpayer to provide such records and documents within the time specified in the notice may result in the expenses being disallowed for deduction.

Further, there is a specific provision in the ITA to disallow expenses claimed by a taxpayer if the taxpayer fails to provide supporting records and documents in respect of such expenses within the time specified in a notice made

...under Section 81. In this regard, Section 39(1A) of the ITA provides that in ascertaining the adjusted income of a taxpayer, no deduction of expenses from the gross income shall be allowed if the taxpayer fails to comply with a notice issued by the DGIR under Section 81 which requires the taxpayer to furnish information in respect of such deduction claimed by the taxpayer.

under Section 81. In this regard, Section 39(1A) of the ITA provides that in ascertaining the adjusted income of a taxpayer, no deduction of expenses from the gross income shall be allowed if the taxpayer fails to comply with a notice issued by the DGIR under Section 81 which requires the taxpayer to furnish information in respect of such deduction claimed by the taxpayer. A deduction is only allowed if the taxpayer submits the records or documents that meet the requirement as specified in the notice issued by the DGIR.

Conclusion

In recent years, external debt as a form of financing has become increasingly common. Many companies including multinational enterprises have external borrowings on which they pay interest and other financing costs. The borrowings may range from multi-billion syndicated loans used to finance a major acquisition or takeover to overdraft facilities used to help manage the working capital of the company.

One advantage of debt financing is that it provides access to a wide range of business finance solutions, enabling the business to expand more rapidly and operate on a larger scale. Another advantage to debt financing is that the financing costs incurred in relation to the borrowings may be tax deductible. This is provided that the financing costs form an integral part of the profit-earning process.

Nonetheless, taxpayers making a claim of these expenses are advised to maintain sufficient records and documents for the purposes of a tax audit. Such records and documents would include books of account recording receipts and payments or income and expenditure, and such other documents as are necessary to verify the entries in any books of account.

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