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Special Commissioners Rule Revenue Cannot Impose Deemed Interest On Third Party Loans

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The Special Commissioners of Income Tax (SCIT) recently delivered a significant ruling on whether deemed interest can be imposed by the Revenue on interest-free loans given to third parties.

The taxpayer in this matter was successfully represented by the firm's Tax, SST & Customs partner, S. Saravana Kumar, together with, associate, Felicia Wong Sie Ying.

Background Facts

The taxpayer carried on a licensed moneylending business, which involved borrowing funds from creditors and advancing loans to its borrowers i.e. debtors. In the ordinary course of its business, the taxpayer extended loans to borrowers at interest rates ranging from 5.25% to 5.68%. These loans were duly accounted for under "Trade Receivables" and the interest earned on these loans was declared as the taxpayer's income and was subjected to income tax.

From time to time, the taxpayer also advanced loans without charging interest to third parties. These loans were recorded separately as "Other Receivables."

In the year of assessment (YA) 2017, the taxpayer advanced two types of loans:

1. Interest-bearing loans on which the interest income was earned and brought to income tax; and

2. Interest-free loans advanced to 139 individuals and companies, who were all third parties.

Following a tax audit, the Revenue took the position that the interest-free loans should have also been subjected to interest. Accordingly, the Revenue imposed deemed interest at the rate of 4% on all the interest-free loans, which resulted in a purported understatement of interest income amounting to RM17,627,101.36. Income tax was imposed on the purported understated interest income and aggrieved by this decision, the taxpayer filed an appeal to the SCIT.

The Revenue's Contention

The Revenue advanced several arguments to support its position for imposing deemed interest on the interest-free loans to third parties:

(a) The primary contention was that the interest-free loans formed part of the taxpayer's stock-in-trade under Sections 4(a) and 24(5) of the Income Tax Act 1967 (ITA). As a licensed moneylender, the taxpayer's "Other Receivables" ought to be treated as income-generating loans, given their significant value in comparison to the interest-bearing loans. The absence of agreements or supporting documentation meant there was no justification for classifying those loans differently. In the Revenue's view, the taxpayer's subsequent cessation of both types of lending after the audit further demonstrated implicit acceptance of the Revenue's decision.

(b) The taxpayer's attempt to distinguish between "Trade Receivables" (interest-bearing loans) and "Other Receivables" (interest-free loans) was artificial and unjustified. Since the loans were made regularly and in the ordinary course of business, they should properly be regarded as part of the taxpayer's normal money lending activity and thus, fell under Section 4(a) of the ITA.

(c) To further support the above, it was contended that the taxpayer had failed to comply with the Moneylenders Act 1951 by not executing moneylending agreements for the interest-free loans. This omission, in the Revenue's submission, undermined the taxpayer's attempt to argue that such loans were non-income generating.

(d) In relation to case law, the Revenue dismissed the taxpayer's reliance on authorities such as *Federal Furniture Holdings Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* (2016) MSTC 130-120 and *MBCB v Ketua Pengarah Hasil Dalam Negeri* (PKCP (R) 46/2009), contending that both were distinguishable on their facts. The former concerned an investment holding company with income assessed under Section 4(c), while the latter dealt with advances to related parties and turned on the scope of Section 140(6) of the ITA.

(e) Finally, the Revenue defended its computation and consequential penalty. It was asserted that the deemed 4% interest rate was reasonably derived from the taxpayer's general ledger, bank statements of its creditors and prevailing bank rates. The imposition of a 45% penalty under Section 113(2) of the ITA was also said to be correct in law and justified, given the taxpayer's alleged understatement of income.

The Taxpayer's Contention

The taxpayer argued that interest-free loans cannot give rise to taxable income under the ITA. By their very nature, such loans do not generate any return to the lender, either now or in the future.

To support this position, the taxpayer relied on earlier decisions. In *MBCB*, the SCIT held that deeming interest on interest-free loans would effectively create a source of income where none exists, which was not permitted under the law. Similarly, in *Federal Furniture Holdings*, the High Court confirmed that interest-free loans do not and will never constitute a source of income.

Building on this, the taxpayer highlighted that Section 4(a) merely identifies the classes of income chargeable to tax. It does not give the Revenue power to deem income, prescribe an interest rate or calculate notional returns that were never earned. Indeed, the Revenue's own witness acknowledged that no such authority existed under Section 4(a).
The taxpayer further pointed out that the ITA does not impose any requirement for loan agreements in respect of interest-free advances or loans to third parties. In any event, no such documents were requested by the Revenue during the tax audit.

As for Section 140(1) of the ITA, the taxpayer submitted that it had no application here. The taxpayer highlighted to the SCIT that only Section 140(1) empowers the Revenue to disregard or re-characterise transactions designed to avoid tax and this provision applies broadly to both related and unrelated parties. However, the taxpayer argued that the interest-free loans in this case were not a device for avoidance. Instead, the interest-free loans were made available in furtherance of a genuine business strategy due to restrictions under the Moneylenders Act 1951. Citing *Ketua Pengarah Hasil Dalam Negeri v OKA Concrete Industries Sdn Bhd* (2015) MSTC 30-091, the taxpayer submitted that the Revenue cannot dictate how a taxpayer chooses to conduct its lawful business.

The taxpayer also objected to the Revenue's use of its own formula to compute the notional interest. Where Parliament intends for income to be calculated using a specific formula, it has done so expressly, for example, in Sections 38(6), 42(2), 63B(1), 103(11) and 107B(4A) of the ITA.

However, there was no such formula under the ITA for interest-free loans given to third parties. In the absence of a legal authority, the Revenue cannot devise its own methodology in the absence of statutory authority. In fact, the Revenue's witness admitted that the formula applied in this case was her own creation, unsupported by any provision of law.

Finally, the taxpayer submitted that the penalty imposed was unjustified. In exercising its discretion, the Revenue must consider all the facts and circumstances of the case and not to impose penalty in a mechanical fashion.

Conclusion

The SCIT delivered its unanimous decision holding that the taxpayer had successfully discharged its burden of proof and, accordingly, the notice of additional assessment was set aside. In reaching this outcome, the SCIT provided brief grounds as follows:

(a) First, interest-free loans, by their very nature, indicate that the borrower was only obliged to repay the principal amount without any additional charge.

(b) Secondly, the SCIT found that there was no provision under the ITA that empowered the Revenue to deem interest on loans given to third parties.

(c) Thirdly, based on the evidence adduced, the SCIT accepted that the loans in question did not generate any return capable of constituting taxable income under the ITA. This was reinforced by the taxpayer's financial statements, which confirmed that the taxpayer's revenue was derived from loans given with interest and not from those without interest.

(d) Finally, the SCIT clarified that it was not the proper forum to adjudicate any issues of compliance under the Moneylenders Act 1951.

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