

Tax Law and Case Law

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ABSTRACT

This article looks at legislation in the context of the Income Tax Act 1967 (as amended) [ITA], its interpretation and the relevance of case laws in assessments. This article was developed from the exposure of the author when interacting with tax practitioners during a recent road show for MIT on tax legislation and case law.

What is Tax?

Section 3 of the ITA reads as follows:

'Subject to an in accordance with this Act, a tax to be known as income tax shall be charged for each year of assessment upon the income of any person...'

The word 'Tax' is defined in section 2 as follows:

'Tax means the tax as imposed by this Act.'

On the other hand, according to the Oxford Dictionary, the word 'tax' means:

'a contribution levied on property or business for the support of government'

One wonders whether the contribution is voluntary or is exacted!

But over the years the issue of what is tax had worked the minds of eminent judges and they had occasionally pronounced their thoughts in the course of their judgments. For example in

*Matthews v The Chicory Marketing Board*¹ the word 'tax' was taken to mean:

'A compulsory exaction of money by a public authority for public purposes enforceable by law...'

Another definition was attempted in *R v Barger* as follows:

'...a process of raising money for the purpose of government by means of contribution from individual persons...'

While the 'definitions' attempted do not give a complete picture of what is 'tax', one could surmise that it has the following badges:

1. It is a compulsory payment
2. It is collected by the government
3. It is not paid for any specific services
4. It is not penalty
5. It is not imposed arbitrarily
6. It is not incontestable (i.e. it can be challenged or appealed against)

Type of Taxes

Economists classify tax into two broad types:

- Direct taxes; and
- Indirect taxes

Direct taxes are imposed on a person directly. Income taxes for example on employment income, business income or investment income and real property gains tax on disposal of a chargeable asset are good examples.

Indirect taxes include *ad valorem* as well as specific rates on, for example, goods and services purchased.

Tax incidence

The tax burden can fall on the taxpayer in different ways. It could be progressive, proportional or regressive. Progressive incidence occurs when the tax imposed is higher as the income increases. Proportional incidence would arise when the taxes imposed are in proportion to the income. Regressive taxes arise when the taxes decrease as the income increases.

Tax system

Whether the tax system administered by a nation is a

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good system or not is always a matter for debate. More than 230 years ago, a classical framework that is often used to define a good tax administration system was laid down by Adam Smith in his famous work *'The Wealth of Nations'*³

Among the features that should be present in a good tax system as envisaged by Adam Smith are:

- Equity and fairness
- Certainty of taxability
- Simplicity
- Neutrality
- Transparency
- Revenue predictability

Equity and fairness

Equity and fairness incorporate the principles of horizontal equity and vertical equity, implying that two different taxpayers with equal income abilities should pay the same amount of tax, while person with varying capacities pay differently. The concept of vertical equity is often achieved with the graduating tax scale rates.

Certainty

Certainty of taxes implies that there is no ambiguity in the application of a tax law to income or deductions. The taxpayer should be able to determine with reasonable certainty whether a particular income is taxable or a particular expenditure is deductible. But this objective appears to be quite difficult to achieve. As there is a need for objectivity in its determination, the law should be clear and simple, and its

implementation should never be dependent on the subjective evaluation of the Revenue officers.

Simplicity

This is important for both the taxpayer and the tax administrators as simple laws and simple procedures have the attraction of encouraging tax compliance. In a self-assessment environment this is critical.

Neutrality

Neutrality implies that the tax law

Transparency

Transparency is a key factor in tax compliance - and with self-assessment this is very much so. The issue of public rulings by the Director-General of Inland Revenue (DGIR) is an indicator of attempts by the Revenue authorities at transparency.⁶ The annual budget presented in Parliament is another indicator of transparency – in this instance of how the tax monies collected are allocated and spent by the government.

Predictability

At the macro economic level, a good tax system should predict, with sufficient certainty, the amount of taxes that would be collected. The system should preferably be devoid of impacts from cyclical fluctuations in the economy. This objective could be achieved with a good mix of direct and indirect taxes that would provide the government with a reliable and stable base for a predictable revenue collection.

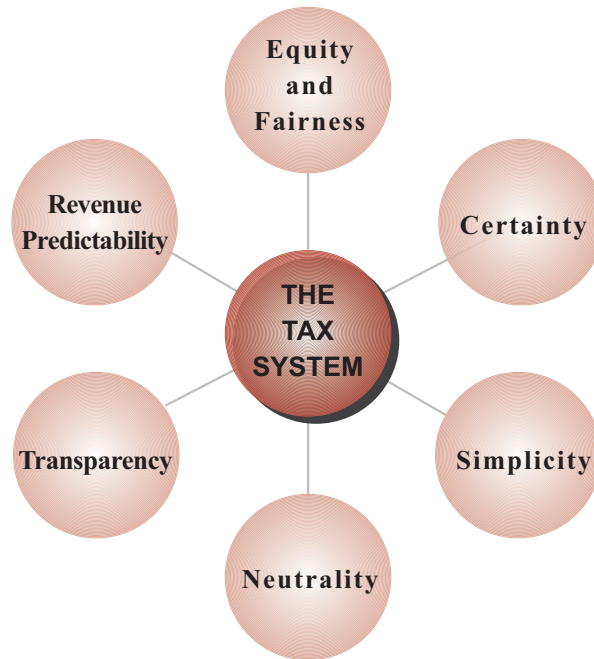


Fig 1
A good tax system

should never be a consideration in any commercial transaction. However with taxes taking away between 20 and 28 per cent of a company's chargeable income,⁴ it is difficult to overlook its impact on a taxpayer's commercial transaction decisions. The emergence of advance rulings for example, are further indicators of such concerns.⁵

Sources of tax law

Sources of law, generally speaking, have several meanings. For example it could refer to historical sources, places where the law can be found like in law reports or the statutes. But usually, it is the legal rules which make up the law that is usually taken as the source of law and understood in that context. Sources in the context of legal rules which make up the law can, in the Malaysian context, be classified for purposes of convenient reference,

into written [for example, the Income Tax Act 1967 (as amended)] and unwritten law (for example, the case law decisions).

In the context of the income tax, there are three sources of law:

- Statute law
- Case law
- Administrative law

“Statute or Statutory law” are laws enacted by Parliament. The Income Tax Act 1967 (as amended) and the Real Property Gains Tax Act 1976 (as amended) are examples of statute law.

“Case law” are the accumulated decisions of the courts and are valuable for the decisions as well as the reasoning and the opinions expressed by the judges in the course of arriving at the decision. In this context, the Privy Council decisions are highly regarded on account of the quality of its decisions.⁷

“Administrative law” comes about from the practice of the Revenue, which in the course of time are accepted as the ‘norm’ and adhered to by the taxpayers and the tax practitioners. For example in the days of the formal assessment, it was a common practice for the Revenue officers to disallow one-third of such expenditures like traveling, entertainment and food/drink as being not ‘incurred wholly and exclusively in the production to gross income...’⁸

The tax practitioners accordingly accepted this practice and would submit their client’s tax computation, adjusting the net income in the profit and loss

account by adding back one-third of such expenses mentioned earlier.

The administrative practice in the self-assessment system is now made more transparent with the issuance of a public ruling that sets out the practice of the Director-General of Inland Revenue (DGIR). While it does help the taxpayer and the tax practitioners to some extent, there is the danger of the public ruling becoming the reference point for any dispute in taxation.⁹ In several tax workshop sessions conducted by the author, it was observed that the participants, given a tax problem dealing with the issue of deductibility for example, which incidentally was covered by a particular public ruling, were very focused on the statements made in the ruling to the point that the ITA and the relevant applicable case laws were completely ignored when pursuing their arguments for a deduction.

Tax Legislation

Tax laws as enacted by Parliament come with severe constraints. The laws have to satisfy the need for accuracy, cover all possible circumstances and most important, must be unambiguous. This is not an easy demand given the strict interpretation demanded by the courts.

It comes as no surprise that many cases land up in court for an authoritative interpretation.

Do judges make law?

In theory the Parliament makes

the law and the judges interpret and apply them. In other words judges are not lawmakers.

Nevertheless in interpreting and applying the law to a new set of circumstances, they are in effect making laws that are caught in the precedence net and carried down the judicial stream to the lower courts which are bound by the decisions of the superior court.

Lord Reid for example acknowledged the law-making role of judges when he said:¹⁰

‘there was a time when it was thought almost indecent to suggest that judges make law – they only declare it....’

Lord Radcliff too had asserted that judges do make laws.¹¹

‘(there) was never a more sterile controversy than upon the question whether a judge makes law ... of course he does. How can he help it?’

Interpretation of tax laws

Legislation is an attempt by the legislature to formulate a comprehensive law to deal with a particular situation, income or deduction. Sometimes the law so formulated has a tendency to be academic or predictive. The parliamentary draftsman tries to provide for all the possible contingencies using his experience and skill. But the courts in trying to construe the meaning of a particular section may on occasion experience difficulties in applying the specific provision of a statute to a particular situation. Sometimes

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the drafting may have given rise to a lacuna and thus unintended consequences may follow from a judicial interpretation of the statute.

The courts have, over the course of more than a century, developed tools for the interpretation of the meaning of particular word or section in such difficult situations.

The literal rule for example, requires that a particular word be assigned an ordinary meaning as generally understood. In other words the meaning should not be a strained meaning. An interpretation should also avoid any absurdity if interpreted literally, and above all avoid the mischief that it was designed to prevent.

If the words have attained a technical meaning, then it should be given a technical meaning.

For example the word 'income' can be given its ordinary meaning, or it could be interpreted as a technical word depending on the circumstances, as could be seen in the provision of subsection 2(2):

'...reference in this Act to income shall if the income is not described as being income of a particular kind, be construed as a reference to income generally or to gross, adjusted, statutory, aggregate, total or chargeable income as the context and circumstances require'

The courts sometimes apply the class rule for the interpretation of a particular word or words. In this rule, the general word or words

that follow a particular or specific words of the same nature takes on its meaning from those words that precede it; in other words the specific words are molded and aligned in its meaning by the words preceding it. For example in section 48(1) (b) (i), in respect of child relief, the law reads as follows:

'...receiving full time instruction at any university, collage, school or other similar educational establishment...'

While the words 'other educational establishment' is not specifically

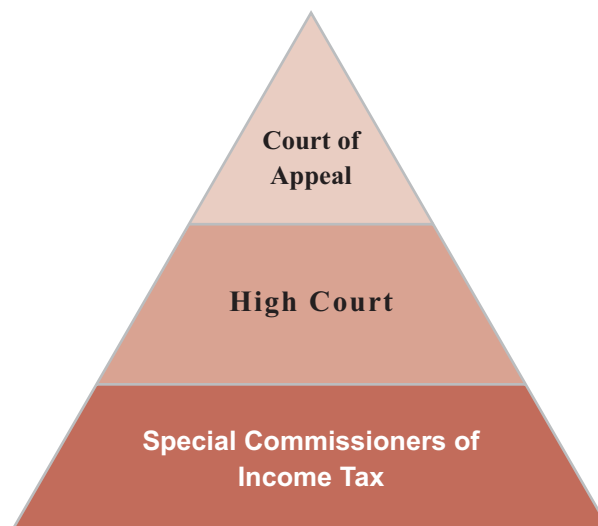


Fig 2
The court hierarchy in tax cases

defined, the courts have shown that in such instances, one could interpret the words to mean 'an educational institution similar to that of a university, college or school...'¹²

Generally the courts have tended to interpret the tax laws strictly because it imposes a burden on the taxpayer. This strict approach has support from Rowlatt, J's dicta in *Cape Brandy Syndicate*:¹³

'...in a taxing statute, one has to look

merely at what is said. There is no room for intendment...nothing is to be read in, nothing is to be implied...only look fairly at the language used...'

As a result where the law is not clear, the courts are more than happy to give a decision in favor of the taxpayer.¹⁴

Case laws

Case laws are valuable for the decision made by the judges on contentious issues brought to the courts. These decisions are made more valuable by the practice of precedence i.e. following the legal principle of an earlier case, and also for the judicial reasoning given or considered in reaching particular decisions. In this context, the opinions expressed by some eminent judges in the course of arriving at a decision are highly valued as a guide to the interpretations of the legislation.

The Doctrine of Precedence

For the proper working of the doctrine of precedence, it is essential that the system of court hierarchy be observed. The general rule is that the decision of the higher court binds the lower courts and some courts are bound by their own decisions. The decision of subordinate court does not create binding decisions but they are bound to follow the decision of the superior courts.

Thus case law authority is closely linked to the court hierarchy.

Application of case laws

Tax practitioners must be careful in applying decided case law to a particular situation or transaction. It would be prudent to consider the particular facts of the case, the evidence used to support the facts, the nature of the transaction, and the intention of the parties etc and ensure that these are exactly, or very similar with no distinguishing factors, to the client's situation before arranging the tax affairs to fall in line with the decision in a particular case.

Furthermore, in applying decided cases, one should note the question of law involved.

Even where the situation is on "all fours" with the case at hand, there is no guarantee that the case chosen to support the situation or transaction would be

accepted by the Revenue.¹⁵

Concluding remarks

Interpretation of the tax statute requires a sharp legal mind and the acumen of a shrewd businessman for its application to a particular commercial transaction. One could therefore choose to play safe and tread the beaten path (it is very safe to follow the public ruling!) or alternatively where one is seeking an adventure into the unknown, it would be advisable to secure the services of a qualified tax accountant and a tax lawyer to act as guides to take you through the treacherous legal jungle and technical swamp that abound the murky tax laws.

Such adventures do not guarantee that the taxpayer would come out financially unscathed.

Ref:

1. Beatrix Vohrah and Wu Min Aun, *The Commercial Law of Malaysia*, Petaling Jaya, Longman 2000
2. Cross R, *Precedent in English Law*, London, OUP, 1961
3. Income Tax Act 1967 (as amended)
4. Interpretation Acts 1948 and 1967
5. Jayapalan Kasipillai, *A Compressive Guide to Malaysian Taxation Under Self Assessment*, Kuala Lumpur McGraw Hill, 2005
6. Tun Mohamed Suffian, *An Introduction to the Legal System of Malaysia*, Petaling Jaya, Penerbit Fajar Bakti, 1988
7. Veerinderjeet Singh, *Malaysian Taxation – Administrative and Technical Aspects*, Petaling Jaya, Longman 6th Edition, 2003
8. Wu Chin Aun, *The Malaysian Legal System*, Petaling Jaya, Longman, 2000

FOOTNOTES

1. [1963] 60 CLR 263
2. [1908] 6 CLR 41
3. See *The Wealth of Nations* edited by Edwin Cannan, New York, 1994 pp. 887-890
4. Under Schedule 1 of the ITA the tax imposed on the chargeable income of a company with a paid up capital of RM 2.5m and below at the beginning of the basis period on the first RM 500,000 of the chargeable income is 20% and on the subsequent chargeable income is 28%. Companies with a paid up capital exceeding RM 2.5 at the beginning of the basis period is 28%, effective from the year of assessment 2006. For the year of assessment 2007, the rate of 28% would be reduced to 27% and in the year of assessment 2008, it would be further reduced to 26% (Section 30 of the Finance Act 2006)
5. The Finance Act of 2006 for example provides under Section 138B in Chapter 1A that 'on the application made by any person, the Director General shall make an advance ruling on the application of any provision of this Act...'
6. It is the purported intention of the Director General of the Inland Revenue that a Public Ruling is issued to provide guidance for the public and officers of the Inland Revenue Board. It sets out the interpretation of the Director General of Inland Revenue in respect of the particular tax law, and the policy and procedures that are to be applied.
7. See Nakha Ratnam Somasundaram, 'Ranting and Raving...about Rent' Chartered Secretary Malaysia, Dec. 2004, for a discussion of the impact of the Privy Council decision in the case of *American Leaf Blending v DGIR* [(1979) 1 MLJ 1] which upset the view held by the Inland Revenue Board on the tax treatment of rental income for nearly 25 years.
8. Section 33 and section 39 of the Income Tax Act 1967 (as amended).
9. Section 26 of the Finance Act of 2006 now introduces a new section 138A, which provides for 'the Director General ...at any time to make a public ruling on the application of any provision of this Act in relation to any person ...'.
10. See 'The Judge as Lawmaker' (1972) 12 JSPTL 22, p. 25.
11. 'Law and Order', (1964) 61 Law Society's Gazette, p. 821
12. *Heaselip v Hassemer* (13 TC 212)
13. *Cape Brandy Syndicate v IRC* (12 TC 358)
14. For a comprehensive discussion of the application of a particular section where the law is less than clear, see Nakha Ratnam Somasundaram, 'Ticket to Taxes', Tax Nasional, 2Q/2005.
15. For a discussion of how things can go wrong in some situations, see Nakha Ratnam Somasundaram, 'Horse Tracks ...and Elephant Tracks' Tax Nasional 2Q/2004.

Author's Profile

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The author holds a PhD in Taxation from the University of Newcastle, and is a member of the Malaysian Institute of Taxation. Dr. Nakha was a former lecturer in taxation at the UiTM, The Malaysian Institute of Certified Public Accountants, and the University of Malaya. Dr. Nakha served the IRB for 30 years, retiring in 2001 as the Kelantan State Director. He is currently holding the post of Specialist in Taxation at the Multimedia University, Cyberjaya Campus. He welcomes feedback at nakharatnam@yahoo.com.