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e-CTIM TECH-DT 50/2016 (Revised) **4 July 2016**

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TECHNICAL

Direct Taxation

TAX CASE UPDATE

Whether payments of cash incentive are entertainment expenses under S39(1)(l)

NV ALLIANCE SDN BHD. v. KPHDN

Court of Appeal, Malaysia
Civil Appeal No: W-01-149-2010
Date of Judgment: 4 November 2011

Facts and Issues:

The appellant (the taxpayer) carries on the business of marketing burial plots, urn compartments and funeral packages. It engages agents to carry out the marketing function, who are paid commissions for their services. In order to motivate its appointed agents to increase sales, the taxpayer introduced incentive schemes whereby the agents are paid various incentives upon achieving certain set sales targets. One of the incentives given is cash. The taxpayer claimed deductions from gross income for payments of such cash incentives under S33(1) of the Income Tax Act 1967 (ITA). It is common ground in this appeal, that the deduction claimed is allowable under that provision of the ITA. Nevertheless, the Director General of Inland Revenue (the DGIR) still refused to allow the deduction on the basis that such expenses are entertainment expenses under item (l) of S39(1) of the ITA, which is premised on the definition of "entertainment" found in S18 of the ITA, that reads as follows:

> *Entertainment includes –*
> *(a) The provision of food, drink, recreation or hospitality of any kind; or*
> *(b) The provision of accommodation or travel in connection with or for the purpose of facilitating entertainment of the kind mentioned in paragraph (a),*
>
> *by a person or an employee of his in connection with a trade or business carried on by that person;*
>
> Note: Subsequent to the decision in this case, the above definition has been amended with effect from the year of assessment 2014 onwards to include additional wording (highlighted in yellow) as follows:-
>
> *by a person or an employee of his, with or without any consideration paid whether in cash or in kind, in promoting or in connection with a trade or business carried on by that person;*

(All sections referred to hereafter are references to sections in the ITA.)

The taxpayer appealed against the disallowance to the **Special Commissioners of Income Tax** (SCIT) who found that the expenses on cash incentives were wholly and exclusively incurred in the production of the appellant's gross income under S33(1), and not prohibited from deduction by virtue of S39(1)(l) before its amendment by Act 631 of 2003.

The DGIR then appealed to the **High Court** which allowed the appeal and reversed the Order of the SCIT. In the High Court judgment, the case of *Bentleys, Stokes & Lowless v Beeson*

(Inspector of Taxes) was cited as establishing the principle that to qualify for deduction, the purpose (of producing income) must be the "sole purpose" of the expenditure. "*If the activity be undertaken with the object of both promoting business and also with some other purpose….then this paragraph is not satisfied….*" The Court found that the cash incentives in this case was incurred for a dual purpose – "*the predominant purpose of promoting the Respondent's business*", as well as "*paid to reward those sales agents who achieve the sales target set*." The Court also found that there is the element of "hospitality" in the incentives based on the case of *United Detergent Industries Sdn Bhd v DGIR.* Since entertainment is defined in S18 to include "*hospitality of any kind*" and having considered the facts, the Court held that the SCIT erred when it concluded that the incentives do not come within the meaning of entertainment.

The taxpayer appealed against the High Court's decision.

Decision:

Appeal allowed. The Order of the High Court was set aside and the Deciding Order of the SCIT restored.

The grounds of decision are summarized below:

1. The Court did not agree with the decision and reasoning of the High Court, but held the contrary view that the incentive payments are not 'hospitality' expenses and hence, are not 'entertainment' expenses under item (l) of S39(1). Therefore the taxpayer is entitled to deduction of the expenses.
2. The Court agreed with the submission of counsel for the taxpayer that the ***noscitur a sociis*** rule of statutory interpretation is applicable in this case.

   "*According to this rule, where 2 or more words which are susceptible of analogous meaning are coupled together in a statutory provision, they are understood to be used in their cognate sense. They take as it were, their colour from each other, the meaning of the more general being restricted to a sense analogous to that of the less general…..(In) the present case, the meaning of the more general words 'or hospitality of any kind' must be restricted to a sense analogous to that of the less general words, namely 'food, drink, recreation'……In our view, if the meaning to be given to the words 'or hospitality of any kind' is limited accordingly, then the cash incentives expenses clearly cannot come within the meaning of these words ('or hospitality of any kind')*"
3. The same conclusion is arrived at by applying the **ejusdem generis** rule. Applying this rule, the meaning to be given to the general words '*or hospitality of any kind'* must be restricted to the same genus as *'food drink, recreation'.* If the meaning of *'hospitality of any kind'* is so confined, clearly it would exclude the payments of cash incentives.

Members may read the full Grounds of Judgment at the Institute website and the LHDNM website.