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CHARTERED TAX INSTITUTE OF MALAYSIA (225750-T)

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TECHNICAL

Direct Taxation

TAX CASE UPDATE

Whether incentive trips paid for dealers come within the meaning of entertainment in S.18 which is not deductible under S.39(1)(l)

KPHDN v KHIND-MISTRAL (BORNEO) SDN BHD

KHIND-MISTRAL (BORNEO) SDN BHD v KPHDN

High Court in Sabah & Sarawak at Kuching
Tax Appeal: KCH-14-2-2011
Date of Judgment: 14 Sept. 2011

Facts and Issues:

(All sections quoted are from the Income Tax Act 1967 (ITA), unless otherwise stated.)

This is an appeal against the decision of the Special Commissioners of Income Tax (SCIT) who decided on 25.11.2010, that incentive trips paid for the dealers of the company, Khind-Mistral (Borneo) Sdn Bhd. ("the Taxpayer"), who have reached their sales target, are expenses deductible under S33(1) of the ITA, but they came within the meaning of "entertainment" in S18 and are therefore not deductible under S39(1)(l). The SCIT also decided that the Inland Revenue Board (IRB), the appellant in the first appeal, cannot impose a penalty under S113(2) of the ITA as the company "*had made full disclosure and the expenses were clearly and correctly described*", and there was no intention to mislead or evade tax. Both parties, being dissatisfied with the decision, appealed to the High Court.

The Taxpayer was in the business of dealing and trading in electrical products. In 1996, it introduced an incentive scheme for dealers dealing in its products, which rewarded those who have reached their sales targets by giving them trips to their local factory and tourist destinations both local and abroad. This incentive was given in addition to the commissions and discounts given to dealers. For the year of assessment (YA) 2000(CY), YA 2002 and YA 2003, expenses on these incentives were claimed under S33(1). However, the IRB decided that these expenses came within the meaning of "entertainment" under S18 and not allowable under S39(1)(l). It also imposed a penalty of 60% of the tax undercharged under S113(2).

The Taxpayer then appealed to the SCIT, whose decision led to this appeal to the High Court.

Decision:

The taxpayer's appeal is allowed and the IRB's appeal dismissed. The grounds of the decision are summarized below:

1. The issue in this appeal centred on the interpretation of the relevant provisions of a statute. In discharging this function, the following principles (based on case laws cited) are to be observed:
   - The court must give effect to the natural and ordinary meaning of the words. Only when

meanings are in doubt will recourse be made to the preamble in order to understand why the legislation was enacted in the first place. However, the Judge added that *"(s)uch recourse is of course not warranted in this case*."

- When interpreting a taxing statute, the interpretation must be strict. (Cape Brandy Syndicate v IRC (1921) 1 K.B. 64 and Palm Oil Research And Development Board & Anor v Premium Vegetable Oils [2004] 2 CLJ 265.)

2. The IRB cited KPHDN v NV Alliance Sdn Bhd (Civil Appeal No. R1-14-04-2009) in which it was held that payment incentives are gratuitous in nature and made without consideration, and because S18 defines 'entertainment' to include '*hospitality of any kind'*, the incentives come within the meaning of 'entertainment.' The Judge agreed (with the contention) that the facts in the present case are similar to the cited case, in that the incentive trips were given over and above commissions and discounts given to dealers.
3. However, the Taxpayer's counsel contended that the above case should not be followed in the light of the Court of Appeal decision in Aspac Lubricants (M) Sdn Bhd v KPHDN [2007] 5 CLJ 353 where it was posited that the "*proper approach in determining whether the expenses….were incurred in the production of income, is to examine the true nature of the transaction between the appellant and its customers*" (supported by quotes from the case of Bentleys, Stokes & Lowless v Beeson(1952) Vol. 2 All ER 82).
   The Judge in the present case summed up the decision in Aspac as follows:
   > " *where there is consideration moving from the customer to the appellant (taxpayer) in the form of payment for the product sold, then the expenses incurred for these promotional items or gifts for the products are not entertainment expenses under the Act. According to His Lordship* (in the Aspac case) *these promotional gifts were 'bargains made by the appellant for the sole purpose of business promotion and hence fall within the basket provision*.' "
4. The Judge in this case declared that the "undeniable fact" was that in both the Aspac case and Bentleys case, the court stressed on the business promotion aspect of the expenses claimed, and that even if the activity had "….*some connection with a trade or business carried on by that person*" the *"business promotion"* aspect of the activity is the material consideration.
5. The Court made note of the following aspects of the incentive trips in this case:
   - They were only given to those who have achieved their sales target, and this meant boosting the sales of the taxpayer's products and therefore its income.
   - The only reason for giving these trips was that sales target had been achieved.
   - The "consideration" spoken of in the Aspac case is evident in this case, that being the dealer's achievement of the sales target set by the company.

   For the above reasons, the expenses are not "entertainment" within the meaning of S18.
6. The trips do not come under "hospitality" as provided under S18. The meaning of that word was explained in United Detergent Industries Sdn Bhd v DGIR [1999] AMR 462 as "*the action of entertaining someone without that person having to subscribe towards the cost incurred by the host for the purpose of entertaining that someone*." The company was not being hospitable in the natural and ordinary meaning of the word. The trips have to be "earned" in the sense that only those who have achieved the sales target (thereby contributing more income to the company) are entitled to the trips.

Note:

The definition of "entertainment" in S.18 has since been amended with effect from the year of assessment 2014 onwards, to include additional wording (highlighted in yellow) 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, 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;

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