

Tax Nasional

Official Journal of The Malaysian Institute of Taxation

4th Quarter/2002

RM38.00







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- 8. Any person who is an approved Tax Agent under Section 350 of the Income Tax Act, 1967.

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A Fellow may be elected by the Council provided the applicant has been an Associate Member for not less than five (5) years and in the opinion of the Council he is a fit and proper person to be admitted as a Fellow.

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- 7. Certified copies of:
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 (b) All educational and professional certificates in support of the application
- 2. Two identity card-size photographs.
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Every member granted a change in status shall thereupon pay pe prescribed.

The Council may at its discretion and without being required to assign any reason reject any application for admission to membership of the institute or for a change in the status of a Member.

Admission fees shall be payable together with the application to admission as members, such fees will be refunded if the application is not approved by the Council.

Annual subscription shall be payable in advance on admission and thereafter annually before January 3.1 of each year.

BENEFITS AND PRIVILEGES MEMBERSHIP are:

- Members enjoy full membership status and may elect representatives to the Council of the Institute.
- The status attaching to membership of a professional body dealing solely with the subject of taxation.
- Obtain of technical articles, current tax notes and news from the Institute.
- from the Institute.

 Obtain of the Annual Tax Review together with the Finance
- Opportunity to take part in the technical and social activities organised by the Institute.

CLASSES OF MEMBERSHIP

ACI.

There are two classes of members, Associate Members and Fellows. The class to which a member belongs is herein referred to as his status. Any Member of the Institute so long as he remains a Member may use after his name in the case of a Fellow the letters Fellow of Taxation Institute, Incorporated (F.I.I.I.), and in the case of an Associate the letters Associate of Taxation Institute, Incorporated (A.I.I.I.).

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- 1. Any Registered Student who has passed the examinations prescribed (unless the Council shall have granted exemptions from such examinations or parts thereof) and who has had not less than five (5) years practical experience in practice or employment relating to taxation matters approved by the Council.
- 2. Any person whether in practice or in employment who is an advocate or solicitor of the High Court of Malaya, Sabah and Sarawak and who has had not less than three (3) years practical experience in practice or employment relating to practical experience in practice or employment relating to practical experience in practice or employment relating to
- 3. Any person who has passed the Advanced Course examination conducted by the Department of Inland Revenue and who has not less than five (5) years practical experience in practice or employment relating to faxation matters approved by the Council.
- 4. Any person who is registered with MIA as a Chartered Accountant and who holds a Practising Certificate and an audit licence issued pursuant to the Section 8 of the Companies Act, 1965.
- Any person who is registered with MIA as a Chartered Accountant with Practising Certificate only and has had not less than two (2) years practical experience in practice or employment relating to taxation matters approved by the Council.



President's Note



he year 2002 was again a momentous year for the Malaysian Institute of Taxation (the Institute) as 2002 was indeed a year of firsts in many aspects, for the Institute.

The Institute currently boasts a total Associate and Fellow membership of over 2,000 practising and non-practising members. Although, this figure may appear small if compared to certain other professional bodies, we must appreciate that membership of the Institute is "voluntary" and unlike certain other bodies, not a condition for practice. As such, a membership of 2,000 clearly highlights the recognition of the benefits of being a member of the Institute.

A more significant first, was the Institute's 2nd National Tax Conference with the Inland Revenue Board, Malaysia on 3rd September 2002. The event was officiated by our honourable Prime Minister cum Minister of Finance, YAB Dato' Seri Dr. Mahathir bin Mohamad and attracted a participation of over 650 delegates and guests. The event marks the maturity of the Institute in hosting an annual, national level tax conference, featuring both international and local tax speakers.

Later, in November 2002, the Institute was represented by a delegation of 17 participants, to take part in the discussion on regional tax issues, at the inaugural Asia-Oceania Tax Consultants Association (AOCTA) Convention in Kyoto, Japan.

Moving on, the year 2003 will be the year for consolidation, where the Institute will be focussing on improving the level of its value added services to the members. The Council is of the opinion, that, in 2003 the Institute should concentrate on more member-oriented activities, which include intensive learning programmes, a member's handbook, etc.

Foremost, the Institute will be looking for new premises to house our secretariat as the future needs of the members will require the Institute to take on additional manpower and facilities, in continuing to ensure that the Institute fulfils it's obligation in meeting the needs of the members.

Next, I have also requested the respective Branch Chairpersons to convene a nationwide members dialogue as one of the many steps to be taken in actively involving members throughout Malaysia in setting the future direction and policy of the Institute.

As domestic tax practice will be affected by the liberalisation of services under AFTA and GATS, the Institute is now in the final process of completing it's memorandum to the Ministry on the need for recognising the Institute as the national tax body representing and safeguarding the interest of the profession.

We again, stand at the beginning of a new year, after having considered our activities in the past year, the Council of the Institute recognises that there is still much to be done for the profession. We are confident that 2003 will be another year of firsts, as the Institute continues in it's role as steward of the profession, protecting and representing the fundamental ethos of the tax "professional" in the country.

On behalf of members of the Council, I wish to conclude by wishing a very warm seasons greeting to all Muslim and Christian members and a very happy new year to one and all.

Ahmad Mustapha Ghazali President

MANNAN INSTITUTE OF TAXATION

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Tax Nasiona

Official Journal of the Malaysian Institute of Taxation

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Commerce Clearing House (M) Sdn Bhd Suite 9.3, 9th Floor, Menara Weld, 76, Jalan Raja Chulan, 50200 Kuala Lumpur, Tel: 603.2026.6003 Customer Support: 603.2026.2003 Fax: 603.2026.7003 Technical Support Hotline: 603.1800.801.813



Creating Value for Professionals

ENOUIRIES

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Designers

Advertising : Sandy Cheung

CCH Asia Pte Limited

: The Secretariat,

Malaysian Institute of Taxation

Subscription and: other enquiries

CCH Asia Pte Limited c/o Commerce Clearing House

(M) Sdn Bhd

: Magic Nine Studio Sdn Bhd

Printers : Hopak Sdn Bhd



Malaysian Institute of Taxation ("the Institute") is a company by guarantee incorporated on October 1, 1991 under 16(4) of the Companies Act 1965. The Institute's mission in enhance the prestige and status of the tax profession in sa and to be the consultative authority on taxation as sto provide leadership and direction, to enable its members metribute meaningfully to the community and development III The nation.

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official publishers of Tax Nasional

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itor's Note

he Finance Minister's speech has been presented, a host of seminars, reports and presentations followed soon after, informing the tax world of the potential impact of the budget 2003 proposals. Some of the proposals

were well received, some were long overdue and some are hoped for again in the next budget. We have in this issue two articles covering the budget. The first, an observation on specific proposals outlined in the budget by Dr Veerinderjeet Singh and in the second, Antony Tong takes a critical look at issues that effect the corporate sector as a result of particular budget proposals. Other issues of interest include:

Gentle Taxation

Suggestions towards a better tax administration and enhancement of tax compliance are forwarded by Dr. Arjunan Subramaniam.

Taxpayers rights – case for judicial review

Following on from Bill Davidson's case for judicial review in the previous issue, we have Lucy Chang sharing her views for 'Judicial Review of Tax Cases". She puts forth the proposal of bringing in constitutional guarantees under the Federal Constitution for achieving a reasonable balance between the extensive powers of the tax enforcers and the fundamental rights of the taxpayers, to enable taxpayers protect some of their basic rights in relation to their statutory obligation to pay taxes and to challenge the decisions of the tax enforcers through judicial review.

A suitable rate of tax

Is government imposing the right rate of tax? Since we didn't get a tax rate reduction, this question of rates probably still lingers on everyone's mind. Kenneth Yong explains the reason for the existence of taxes in the first instance, then goes on to explain its effect on work and productivity and the workings of the Laffer Curve, in modeling the tax rate and productivity relationship to arrive at the optimal rate of tax, theoretically at least. Let's discover if we are paying too much tax!

Reasonable care - Section 114(1A)

Issues faced by those who provide advice or assistance in the preparation of their tax return, as a consequence of an obligation to exercise reasonable care imposed by sec. 114(1A), are explored by Nakha Ratnam. The ITA has many sections, which are vague, too broad or not clear, and is the subject of varying interpretations. As such, proving that one has acted with reasonable care may not be an easy matter.

American Leaf Blending to Pan Century

Celina Wong looks at the overlapping principle expounded in American Leaf between paragraph (a) and paragraphs (c) and (d) of sec. 4 of the Income Tax Act 1967, it's impact on subsequent cases including the current Pan Century Edible Oil case and the ramifications for sources of income being considered incidental, or not, to its main business source.

Bad debts & the refund mechanism for sales/service tax

Bong Sesh Chin discusses issues relating to the refund mechanism for Sales/Service tax on bad debts with hints for the use of the administratively more efficient contra system.

Learning curve

Under the learning curve, Siva Nair completes the final segment on employment income.

E-Commerce Indian perspective

On the regional section, we continue our series on e-commerce with "Taxation of e-Commerce - An Indian Perspective" by Hitesh Sharma & Vikram Doshi.

Proposed Section 75A

The proposed sec. 75A imposes "joint and several liability" upon a "director", which is materially different from the interpretation of "director" under sec. 2 of the Income Tax Act 1967. Section 75A now requires us to focus our concerns on a smaller class of persons i.e. controlling directors. Anand Raj analyses the impact of the proposed legislative amendments suggesting that although it is an improvement (of sorts) over sec. 75(1), it is flawed and still far from reasonable.

Harpal S. Dhillon

EDITOR OF TAX NASIONAL



2nd National Tax Conference 2002

Following the success of the inaugural National Tax Conference 2001, the Inland Revenue Board ("IRB") and the Malaysian Institute of Taxation ("the Institute") once again co-organised the National Tax Conference. The conference carrying the theme "Globalised Tax System in a Borderless World" was held on 3 September 2002 at the Palace of the Golden Horses and was officiated by the Honourable Prime Minister and Minister of Finance, YAB Dato' Seri Dr Mahathir Mohamed.

Whilst last year's conference focused on the need for a change in the mindsets of both the tax authority and taxpayer, this year's conference focused on the growing impact of globalisation on Malaysian revenue law. A total of 11 speakers, comprising international and local tax experts from the government and private sectors offered their views on the various issues affecting our tax system especially those surrounding e-commerce and transfer pricing.

The conference also highlighted the growing transparency now being practiced by the IRB in emphasising issues affecting Malaysian tax. With the rise in compliance from the increased revenue collected by the IRB in the previous year, the successful conference formed part of the missions of both the Institute and the IRB in keeping taxpayers updated and informed on their social responsibilities for the collective good of the nation. In other words, this conference brought the organisers another step closer in achieving its objective to realise a knowledgeable and socially responsible taxpayer.



Welcoming speech by the President of MIT. En. Ahmad Mustapha Ghazali

YAB Dato' Seri Dr. Mahathir Mohamed elivering his keynote address

members' dialogue

As part of the Institute's new vision of providing value added services to its members, a member's dialogue took place in Kuching at the Crown Plaza Riverside Hotel on 29 April 2002. A total of 30 members including an officer from the Royal Customs Department attended the dialogue, aimed at fostering a closer relationship with the members in East Malaysia.

This dialogue served as a platform for communicating activities the Institute had undertaken in the past year. Besides this, the Institute's new vision and mission, its future plans and changes that have taken place were also conveyed to the members by Vice President, Tuan Haji Abdul Hamid bin Mohd Hassan.

Members were later given an opportunity for raising questions to obtain clarification on certain issues. At the end of dialogue, Tuan Haji Abdul Hamid pledged that the Institute would embark on organising a members dialogue nationwide as part of its mission to serve the members.

the members on the projects and activities undertaken by the Institute in the last year to further enhance the status of the tax profession and establishing the Institute as the main tax body in Malaysia.

Mr Chow later shared his views on issues pertaining to the

...in Kuantan As pledged early this year in Kuching, a members' dialogue was

held at the Hotel Vistana, Kuantan on 26 October 2002 as part of the Institute's continuous effort in organising a

nationwide members' dialogue. Organised by the East Coast

Branch, a total of 30 members from the East Coast vicinity

comprising Pahang, Kelantan and Terengganu attended the

Mr Chow Kee Kan, Honorary Secretary of the Institute briefed

Mr Chow later shared his views on issues pertaining to the Budget 2003 and those concerning tax audit investigations. Ms Ng Sock Lee from the Secretariat enlightened the members on the issues raised with the Technical Division of the Inland Revenue Board at its recent dialogue and Mr Wong Seng Chong, Chairman of East Coast Branch, discussed recent tax cases in view of their impact on the tax fraternity.

Members in the East Coast not only had the opportunity of gathering in the recent technical updates but were also able to share and participate in the proposed activities and projects embarked on by the Institute.



On 20 September 2002, our Finance Minister YAB Dato Seri Dr. Mahathir Mohamed presented to the Dewan Rakyat the 2003 Malaysian Budget. The Malaysian Institute of Taxation had the privilege of being one of the first professional bodies in the nation to host the post budget luncheon talk on the 2003 budget. The event took place on 24 September 2002 at the Prince Hotel & Residence, Kuala Lumpur.

Annual Post-Budget Luncheon Talk on 2003 BUDGET

An annual affair of the Institute, this informative Luncheon Talk was led by none other than Puan Kamariah binti Hussain, Head of the Tax Analysis Division, Treasury Department, Ministry of Finance. Puan Kamariah gave an indepth analysis of key issues contained in the year 2003 Budget Proposals and other significant tax developments in Malaysia.



dialogue.

Also, an open forum consisting of representatives from the Royal Customs Department and the Malaysian Institute of Taxation were brought together by the Institute to provide further insight into some of the various measures

put forward by the 2003 Budget. The Royal Customs Department was represented by En Wan Leng Whatt, Pn Hajjah Azizah binti Idris and En Dhajudeen bin Shahul Hameed and Council Member and Executive Director of Ernst & Young Tax Consultants,

Dr Veerinderjeet Singh represented the Institute in the forum, chaired by Deputy President, Mr Michael Loh.

The participants had the benefit of hearing the analysis of tax experts and of the government representatives on the recent budget proposals, after which the 200 participants were treated to a regal lunch.



Mr. Ong Eng Choon is currently the Managing Director of Taxnet Consultants Sdn. Bhd.

He is a member of the Institute of Chartered Secretaries and Administrators, Malaysian Institute of Accountants and the Malaysian Institute of Taxation and a Fellow Member of the Association of Chartered Certified Accountants.

He has over 25 years of experience in tax and consultancy, with also having spent a few of his earlier years with the Inland Revenue Department from 1977 to 1980.

Currently, he is also the secretary of The Penang Community Haemodialysis Society, and the Finance & Taxation Committee Chairman of the Penang Chinese Chamber of Commerce.

Mr. Ong sits on the board of a public listed company as an independent director and acts as Company Secretary for several public listed companies.

Counsel's Opinion

The dust of seminars had hardly settled down when I got repeated reminders on my December article. And now it issues from my hand – Taxila, the art of raising taxes or milking the cow gently, or plucking feathers without ruffling the peacock – taxation must not be viewed as an end in itself but a means to an end. Tax policies must change with the times.

The tall buildings have been brought down. Earthquakes strike across the landscape. Storms uproot the trees. A paradise is closed or near closure. And Mt. Etna erupts in its pristine splendour and glory...

These are turbulent times. Foreign direct investment has become a challenge. Domestic investments have become an urgent need. Seminars have participants, doctors have patients; lawyers have clients. And the Inland Revenue has taxpayers. Each profession has a code of conduct and so must the Inland Revenue and the taxpayers.

One of the best-run agencies of the Government is the Inland Revenue. It has been so since 1947. There is no reason this trend would not continue in the future years. The 2003 Budget proposes to:

- i) enhance tax compliance, and
- ii) intensify enforcement by Revenue Agencies.

Towards a better tax administration and enhancing tax compliance, the following is suggested:

Greater Flexibility in Submission of Tax Returns.

Self-assessment and the current year of assessment have enhanced tax collections, together with the comprehensive withholding tax system. Bearing these important developments in mind, there should be greater flexibility in granting extra time in the submission of tax returns. Self-assessment implemented concurrently with a current year system has imposed heavier demands on both Revenue officers and tax agents. It follows that a call for greater flexibility in the submission of returns is in order.

The Art of Gentle Taxation

By Dr Arjunan Subramaniam



ii) Full Imputation System to be abolished.

Currently, company taxation is on the full imputation system. This system imposes a burden on the Inland Revenue in terms of monitoring the declaration and compliance of dividend income declaration in the returns. There is the question of repayments under sec. 110, Income Tax Act, 1967. The time has come to review the system, particularly the tax exemptions granted to various companies. If Malaysia is to face the challenges of free trade under the World Trade Organisation, it is time to review subsidies to companies in terms of tax exemption. If the full imputation

system is abolished in favour of a single rate of tax on companies with no tax upon the dividends, administrative work can be reduced and the company tax rate can be reduced. Exemption from tax for certain entities must be reviewed to stop this leakage in the tax system.

iii) Interest on Repayments Due more than 3 months.

Where the Revenue authorities take more than 3 months in repayments due to taxpayers, interest at the commercial rate ought to be charged. This will certainly enhance the efficiency of the Revenue.



Tax Appeal to be forwarded to the Special Commissioners within 3 months.

Currently, the Revenue has 12 months (and more if extended) to submit appeals to the Special Commissioners. It is noticed that the process of forwarding appeals is rather slow. Taxpayers' claims must be speedily heard and disposed of. Towards this aim, Revenue's review of appeals need greater attention. The attitude - "Let the Courts decide" is to transfer responsibility from Revenue to the Courts. If a taxpayer's case is strong, the Revenue should be bold enough to decide the case in favour of the taxpayer.

Code of Ethics for Revenue Officers upon a Raid.

The general public and taxpayers must understand, the need for Revenue to undertake "raids" on taxpayers. In the main, Revenue officers have conducted themselves professionally - firm and polite. To continue such conduct and to weed out exceptions that might arise, there is a need for code of conduct for Revenue officers. Taxpayers too need to undertake professional advice as to how best to deal with Revenue officials. A code of conduct for both sides is needed.

vi) Replying to Taxpayers' Letters.

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The Revenue must ensure that taxpayers' letters are speedily replied. Certain Revenue officers reply promptly. But others do not. Here

again there must be a "code" to reply to taxpayers. And taxpayers too must also and equally give replies to the Revenue on a timely basis.

vii) Maintenance of Accounting Records.

With self-assessment and the current year of assessment, taxpayers must maintain their own archives of their accounting records. In a case a company selling its land in 1995, the accounts of 1973, when the land was purchased, were not available to establish the accounting treatment accorded in the accounts!

viii) Understanding Revenue Principles.

A number of taxpayers give all attention to their business of making profits. But hardly give their time and attention to see how the Inland Revenue works. Principles of taxation are unknown to them, until upon a raid it is discovered that what is allowable for commercial purposes of arriving at profit, may not be allowable for income tax purposes. Taxpayers rely heavily on the tax agents. It is time that the tax agents and the auditors are different entities to ensure cross checking.

Treatment of Tax Evaders: No Prosecutions.

The 2003 Budget recognises that foreign direct investment is slowing resulting in a need to foster domestic investment. In the light of the current world events, it is imperative to ensure that tax evaders, even the hardcore, are not prosecuted. The climate is not right for such measures and therefore, they must be treated only with heavy fines with a hope they would reform. We cannot afford to kill the Golden Goose, even if it is delinquent. These are turbulent times and must be tread-on carefully. With the opening up of China and India, there is keen competition for investments. The writing is on the wall. We should not fail to read it, and act upon those words of caution.

Taxpayers must upgrade their tax compliance capabilities and ensure that all income is fully declared. This does not mean they cannot tax plan. Tax mitigation is allowed, but not tax avoidance (where there is no economic substance to a transaction) or tax evasion (outright nondeclaring of income). Give unto Caesar what belongs to Caesar; then the rest shall be your happiness...

The Author

Dr. Arjunan Subramaniam is an advocate & solicitor, and a partner in Messrs Geraldine Yeoh, Arjunan & Associates. He worked in the Inland Revenue Department for 20 years and when he resigned to join the private sector he was an Assistant Director General. He is an adjunct professor, School of Accounting UUM. He is the author of Malaysian Taxation System - Self Assessment, 2002 Sweet & Maxwell Asia and The Malaysian Stamp Duty Hand Book, 2002 Sweet & Maxwell Asia, Currently he is working on a mammoth project on Revenue Law, namely Arjunan on Malaysian Revenue Laws, Sweet & Maxwell Asia comprising direct and indirect taxes to be launched in November 2002,

THE 2003 BUDGET IN RETROSPECT:



By Dr Veerinderjeet Singh

any commentators have described the 2003 Budget as being an uneventful one. Notwithstanding this, it was a pragmatic budget, which was clearly focused on the need to achieve fiscal adequacy (in terms of government revenue), to reduce the fiscal deficit (2003 would be the sixth consecutive year of budget deficits) and to give a push to local investors to generate the kind of growth that would assist in enhancing the country's resilience.

Thus, the 2003 Budget can be said to have adopted an interesting stance in the face of globalisation and technological advancements, which are pervading economies all around the world. Nevertheless, foreign direct investment is still important and the incentives announced for regional distribution centres (RDCs), international procurement centres (IPCs) and operational headquarters (OHQs) indicates a shift towards an emphasis on the setting up of hubs in Malaysia.

What do we say?

One cannot help but notice that the Government has taken the view to micro manage (as in granting incentives for selected industries) rather than to take the macro view which would involve granting across-the-board tax cuts. There are various arguments for and against this approach. Suffice to say that we can talk about the low effective tax rate (for some sectors) in Malaysia but what about the non-tax aspects? Are we competitive in these areas? Can we remove the various impediments/obstacles to doing business in Malaysia?

A great start has been made in the 2003 Budget in trying to remove some of the so-called impediments and to assist in reducing the cost of doing business in Malaysia. The most significant development for the corporate sector this time is that, the Government listened to the various requests made by the corporate sector (other than for tax rate cuts). One hopes that subsequent budgets will continue with this thrust in our drive to achieve developed nation status.

The Gross Domestic Product (GDP) growth rate for 2002 of 4% is achievable, but the 6% to 6.5% growth for 2003 seems optimistic. Of course, a lot depends on what happens to the world economy. The private sector has been thrown a challenge by the Prime Minister – it must be aggressive and venture into new frontiers – but the issue is whether there will be a "take-up" of the range of incentives announced. It will take a while but incentives alone are not enough and there must be all-round concerted action and desire on the part of all parties to meet the challenges.

Some of the well-received changes are as follows:

- removal of withholding tax for services rendered outside Malaysia by non-residents after nearly 18 years. (However, it would have been even better to have removed the whole of sec. 4A of the *Income Tax Act*, 1967 (ITA) and to address the possible overlap with sec. 107A which refers to withholding tax on non-resident contractors).
- removal of service tax on services rendered within a group of companies (one fears that the authorities may have a narrow outlook on what constitutes inter-company services let us see!).
- bad debt relief in respect of sales tax and service tax (but one needs to meet various conditions and then apply for a refund of the tax that had been paid

 why not allow a set-off against any sales tax/service tax due in a subsequent period?)
- deduction for the cost of acquiring a foreign owned company.
- incentives for RDCs, IPCs and OHOs.
- reduction of penalties for late stamping of documents (Note: the increase in penalties was introduced less than two years ago)
- removal of sec. 11 of the ITA relating to the value of a second home being deemed as a taxable source (probably a section rarely referred to previously)



- amendment to sec. 108 of the ITA to allow a discretionary power to the Inland Revenue Board to remit all or part of the penalties that can be imposed for the over-franking of dividends.
- amendment to sec. 75 and introduction of sec. 75A to the ITA on the liability of directors for the unpaid income taxes due by a company (a good move but it did not go far enough to limit liability to only situations where a director misappropriates company funds for personal benefit).

As for some items that may be frowned upon, the following comes to mind:

a corporate tax rate cut for so-called small companies for the first RM100,000 of chargeable income - a tax saving of RM8,000 only. However, this proposal, depending on the tax profile of the small company and the shareholders, can actually result in a tax burden as high as 35% (instead of a 28% burden under current provisions) where profits flow out as dividends. There are ways of preventing this by allowing companies to have two franking pools (of 20% and 28%) or better still, allow companies to choose a 28% tax rate and leave things as they are. One could say that the 20% tax rate is illusionary or that it may even create a nightmare (for those companies where most of the profits are declared as dividends and the effective tax rate

is much higher). It is expected that the authorities would be making the necessary amendments to allow such small companies to frank dividends at 28%, which would solve the issue stated above.

- too many agencies are now involved in processing various applications for incentives - Ministry of Agriculture, Ministry of Primary Industries, MIDA.....
- lack of clarity in terms of the eligibility for incentives, definitions of various terms, time frame for issuance of guidelines, application forms and exemption orders, etc. It is understood that most of the guidelines, etc may be issued by 31 December 2002. It is hoped that this will be the case. On hindsight, why not make the incentives effective from 1 January 2003 instead?

The 2003 Budget has widened investment incentives, and has addressed certain key issues which previously hampered efficiency and increased the cost of doing business, such as the imposition of withholding taxes on services rendered overseas by non-residents, the imposition of service tax in relation to inter-group services, etc. The abolishment of these taxes has been long awaited and is welcomed.

No measures were taken to increase taxes or to introduce new taxes. However, it was stated in the Budget that efforts will be intensified to enhance tax compliance through enforcement. When one looks at the fact that revenue from direct taxes increased by 44.4% in 2001 (apparently attributed to the selfassessment tax system) and that the IRB is therefore looking at achieving a higher target, one can only hope that enforcement will be tempered with moderation and that the authorities do not lose sight of the big picture. In general, the tax profession believes that the IRB is progressing towards becoming a service-oriented entity and is keen to have constructive feedback so as to improve further. However, being overly motivated by targets should not compromise common sense and taxpayer services.

While it is recognised that the effective tax rate in Malaysia (after taking into account the various Incentives available) is competitive, to give the country the extra edge that may be required to spur growth, a further reduction in the tax rates should be considered in the next Budget.

Once again, it is noted that the Goods & Services Tax, which exists in several Asia-Pacific countries has yet to materialise in Malaysia. As the Government wishes to be prudent in its Budget policies, this is an area that it might wish to consider in the future as this could significantly assist the Government in meeting its objective with regard to fiscal adequacy.

The Author



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Note: The views expressed in the article are the personal views of the author.

THE 2003 BUDGET

...a review of specific proposals

nce again, the Finance Minister and also Prime Minister, Datuk Seri Dr. Mahathir Mohamad, in tabling the Budget 2003 in Parliament, has resisted calls to reduce the present corporate tax rate of 28%, citing reasons such as that the Malaysian tax incentives actually reduces the effective tax rate and that Malaysia does not impose tax on dividends. The 28% rate has been in effect since year of assessment 1998.

By Antony Tong

The Prime Minister explained that the drop in foreign direct investment (FDIs) in Malaysia, is not due to the high corporate tax rate but rather that foreign investors are focusing their attention on China. He said that even if Malaysia reduces the corporate tax rate, FDIs will still go to China.

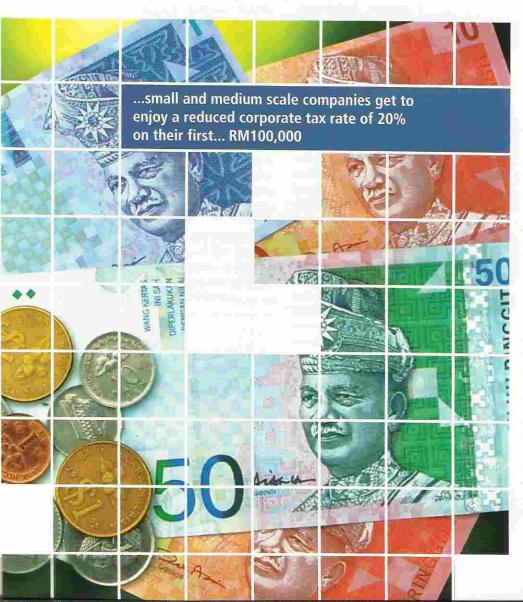
He added that Malaysia's economic growth for decades has been overly reliant on external sector developments, FDIs and international trade. He stressed that it is time that growth must be driven domestically and generated by our own resources as well as greater domestic investment activities. He added that the private sector must resume its role as the main driver of economic growth in Malaysia, as the government could not continuously implement expansionary fiscal policies.

and medium scale companies ("SMC") Instead of a cut across the board, what was proposed is that small and medium scale companies get to now enjoy a reduced corporate tax rate of 20% on their first chargeable income of RM100,000.00. This effectively translates to a tax savings of RM8,000.00. Unfortunately, chargeable income in excess of RM100,000.00 will continue to be taxed at 28%. Although this seems little for a company to save in taxes, the Government estimates a loss of revenue of some RM270 million from the

Two-tier corporate tax rate for small

What are small and medium scale companies? The Finance (No 2) Bill 2002 defines it as "a company resident in Malaysia which has a paid-up capital in respect of ordinary shares of two million five hundred thousand ringgit and below at the beginning of the basis period for a

implementation of this proposal.



year of assessment". The Bill is expected to be amended to define such companies as having ordinary share capital of RM2.5 million or less.

The amount of ordinary paid-up share capital appears to be the sole criteria as the SMC can be involved in any business or industry. Interestingly, even pioneer status companies would be eligible for this tax rate on the balance of their profits (after exemption at statutory level) provided they meet the above condition. This proposal is effective from the Year of Assessment 2003.

SMC and its section 108 ramifications

Whilst the intention of reducing the tax rate for SMCs is praise-worthy, the dividend franking rules for such SMCs have also been amended to be in line with this reduced rate. It is proposed that dividends declared by SMCs will also be franked at 20%.

On Budget night itself, my colleagues were poring over this proposal and realised the ramifications, of what is now known as the "dividend trap", of this proposal for holding companies on dividends received from their SMC subsidiaries. In certain circumstances, the "dividend trap" can result in a higher effective tax rate for both the paying and receiving companies combined (see "dividend trap" illustration on page 12).

For example, the SMC declares a dividend which carries a credit at 20%. If you are a corporate shareholder and not a SMC (i.e. your capital is more than RM2.5 million) or if you are an individual who is taxable at the highest bracket (i.e. 28%), this would mean that you have to pay an additional 8% tax on the dividends which you receive from the SMC. This can be illustrated as follows:

eill

	RM
Dividends from SMC	
is RM100,000.00	
Tax on gross dividends	
(28% x 100,000.00)	28,000.00
Less: Section 110 tax credit	20,000.00
Additional tax	8,000.00

Or, if you are a non-resident shareholder, your tax is at 28% whilst the credit attached to a SMC dividend is only 20%. The Malaysian Revenue can legitimately go after you for the additional 8% tax.

The only situation where one avoids the adverse effect of this proposal is where the shareholder is a resident individual at a tax bracket of below 20% or another SMC with RM100,000.00 or less of chargeable income.

As a result of this proposal, one of my clients who has a group of companies is contemplating increasing the ordinary share capital of all his dividend-paying subsidiaries to above RM2.5 million. My client also asked me, whether for a SMC utilising "old" franking credits (i.e. arising from tax at 28%) the SMC dividends would still attract a credit of 28%. The answer is no. The tax credit attached to all dividends declared by SMCs is now 20%, irrespective of the fact that the company plans to utilise the accumulated franking credits brought forward from earlier years of assessment. The proposal did not provide any flexibility to SMCs to choose and deduct tax on the dividend at the rate of 28%. As such, SMCs have no choice but to declare dividends at 20% net of tax. With these shortcomings, it is hoped that the authorities will quickly rectify the proposal to remove the dividend trap or provide some flexibility for SMCs to declare dividends at two rates.

Withholding tax now less of an issue: scope curtailed

Any tax professional following the application of the withholding tax provisions under sec. 109B of the Income Tax Act 1967, over the years and its apparent conflict with double tax treaties (re SGSS case) should be relieved with this proposal in that sec. 15A Derivation of special classes of income in certain cases has been amended. With effect from 21st September 2002, gross income in respect of the following services shall be deemed to be derived from Malaysia only where such services are performed in Malaysia:

- 1. Amounts paid in consideration of services rendered by a person or his employee in connection with the use of property or rights belonging to, or the installation or operation of any plant, machinery or other apparatus purchased from such person;
- 2. Amounts paid in consideration of technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme.

Though withholding tax is a tax on the non-resident recipient of income derived from Malaysia, it is common practice to see the withholding tax passed onto and be borne by the payer. Where the payer has to bear the withholding tax, this invariably leads to re-grossing in the Malaysian business. This increases the latter's cost of doing business as the re-grossed sum is technically a tax payment and not a deductible expenditure under sec. 33(1).

By proposing that withholding tax will only be applicable if the above two categories of services provided by the nonresident are performed in Malaysia, the previously wide-spread imposition of sec. 109B on virtually almost all types of services rendered by non-residents has been effectively curtailed. The lack of guidance from the tax authorities on what services fell within the ambit of "technical advice, assistance or services", further added to the confusion of accountants and tax practitioners alike in advising their clients on whether withholding tax was applicable on payment to non-residents for services rendered. Now, there is an easy way out as long as the services are not performed in Malaysia, withholding tax is no longer an issue. Of course we will still have to deal with services performed in Malaysia whether or not they fall under the withholding tax provisions of sec. 109B. But for the time being, this new proposal brings some much needed relief.

Two further points. Can I pay after 21 September 2002 for services performed prior to this date and get away from paying the withholding tax? The answer is no. The new proviso to sec. 15A stipulates that, "...this section shall apply to the amount attributable to services which are performed in Malaysia". There is no mention of the date of payments. In a meeting with the professional accounting/ tax institutes on 30 September 2002, the Revenue confirmed that withholding tax is due where services rendered overseas have been performed prior to 21 September 2002. Where part of the services are performed in Malaysia and part of it outside Malaysia, the amount attributable to the services performed in Malaysia would be based on the value of the services rendered, to be determined on a fair and reasonable basis.

The second point is that whilst the above proposal is effective from 21 September 2002, withholding tax would still be required to be remitted to the Revenue until the Finance Bill receives royal assent and is gazetted. This is to avoid the consequences of non-compliance. A refund can be subsequently requested from the Revenue for the tax withheld.

In passing, I should also add that the 15% and 5% withholding tax required under sec. 107A is now reduced to 10% and 3% respectively with effect from 21 September 2002.

Service tax on intra-group services abolished

Together with many others, I have always thought it unreasonable and unfair that the efficiency of having centralised management services is penalised by the imposition of service tax on such services provided in a group of companies. The fact that the service provider may not be in the "business" of providing such management services was of no consequence to the imposition of service tax. I can recall meetings with clients on steps to mitigate or avoid service tax on intra-group services such as:

- Keeping below the licensing threshold
- Moving staff to companies which require their services most
- Question of billing at cost vs. premium
- Cost-sharing arrangements

DIVIDEND TRAP illustrated

A SMC has a chargeable income of RM1 million and it declares all its profit-after-tax as dividends:

Small & medium scale company	Small	& me	dium	scale	com	pany
------------------------------	-------	------	------	-------	-----	------

	RM	RM	Tax Payable RM
Chargeable income Tax Payable : 100,000 @ 20%	20,000	1,000,000	
900,000 @ 28%	252,000	272,000	272,000
Net profit after tax		728,000	
Corporate Shareholder			
Gross dividends (note) Tax Payable: 910,000 @ 28% Less: Tax deducted at source		910,000 254,800	
(20% x 910,000)		182,000	
Additional tax payable		72,800	72,800
			344,800

All this is now history with effect from 1 January 2003, as service tax is exempted on the provision of certain professional services provided to companies within the same group. These types of services are:

[Note: 728,000 x 100/80 = 910,000]

(Effective tax rate = 34.48%)

- Accounting services;
- Legal services;
- · Engineering services;
- Architectural services;
- Surveying, real estate agency, valuation & appraisal services;
- · Consultancy services; and
- Management services.

There is as yet no definition of what amounts to "companies within the same group". One can reasonably assume that it would include a holding company and its subsidiaries.

New Section 75A

Last year saw amendments to sec. 75 which essentially imposes a personal liability on a company's directors and principal officers to pay unpaid corporate taxes where the company fails to settle them. This amendment was quite alarming and since then, there have been recommendations by the various professional bodies to mitigate the effects of the amended sec. 75.

The Government has been sensitive and has proposed a new sec. 75A which stipulates that the liability to pay the tax of the company now lies jointly and

severally with directors of the company during the period in which the tax is liable to be paid. "Director" means any person who occupies the position of director, including any person who is concerned in the management of the company's business and either, on his own or with his associates, owns or controls, directly or indirectly, more than 50% of the ordinary share capital of the company.

With the introduction of sec. 75A, only directors who control a company by virtue of owning more than 50%, directly or indirectly, of the ordinary share capital of the company are now liable. Section 75A becomes effective when the *Finance Act* comes into operation.

Uncollected sales and service tax to be classified as bad debts

Currently, sales tax is due and payable based on billings while service tax is payable within the taxable period although the tax has not been collected from customers. There is no provision under the present Sales Tax Act 1972 or Service Tax Act 1975 that allows for the uncollected tax to be treated as bad debts.

The Government has proposed that the sales tax or service tax paid by a licensee be treated as a bad debt if the licensee is unable to collect the debt from the customer after the expiry of 12 months from the date of payment of tax.

The proposal, effective from 1 January 2003 onwards, is also applicable if the debtor had been adjudged a bankrupt or the debtor has been placed under receivership. The proposal is also applicable if the debtor has been ordered by the court to wind up or the licensee had filed a claim in court to recover the tax or the licensee had initiated action for the customer to be adjudged a bankrupt.

Once the taxes which had been paid are deemed bad debts, the licensee is eligible to apply for a refund of the tax, subject to conditions to be determined.

During a post-Budget session, some participants suggested that the Government allow licensees to offset the bad debts from their next payment of sales tax or services tax. They reasoned that the contra payment will make it easier for companies by not having to keep on paying tax and applying for a refund later, a process which is lengthy and will invariably increase the workload of the Customs Department. The response from the Custom representative was that the contra mechanism is not possible but they will take the appropriate measures to prevent delays in repaying the refunds. It is expected that the Customs Department will soon issue further guidelines on this matter.

Attracting Operational Headquarters and Regional Distribution Centres

To ensure a steady increase in investment in the services sector, approved Regional Distribution Centres will enjoy a full income tax exemption for 10 years (also extended to approved International Procurement Centres), import duty and sales tax exemption on goods for distribution purposes and expatriate posts according to requirements.

In an effort to attract more Operational Headquarters companies (OHQs) and representative offices to operate in Malaysia, the OHQ will be exempt from income tax for a period of 10 years. The expatriates in the OHQ and representative offices will be subject to income tax on the portion of income received during their stay in Malaysia and the condition that requires foreigners including expatriates to be in Malaysia on December 31 and January 1 of the following year in order to be eligible to be taxed as a resident, will be waived.

In certain circumstances, the "dividend trap" can result in a higher effective tax rate for both the paying and receiving companies

Stamp duty exemption for low-cost houses

On 10 October 2002, the government approved a new stamp-duty exemption for purchase of low-cost houses which covers the sale and purchase agreement, instrument of transfer, loan agreement and instrument of charge/deed of assignment. The exemption is given to houses under low-cost housing programmes approved by state governments or local authorities, costing not more than RM42,000.00 in Peninsular Malaysia and not more than RM47,000.00 in Sabah, Sarawak and the Federal Territory of Labuan. The exemption is effective 1 July 2002.

This was not a budget proposal but is evidence that the Government does listen. The property and construction industry received no specific goodies from the 2003 Budget which clearly sent the message that the Government no longer relies on this sector as the sole engine of growth.

I thought of itemising all the Budget proposals but that would be merely repeating what has already been published over and over again. A good source for these proposals is the 2003 Budget Commentary & Tax Information Booklet published jointly by the MICPA / MIA / MIT.

On a lighter note, the Prime Minister said the 2003 Budget may not be his last before his retirement next year as his retirement would only take effect in October 2003. He still has the opportunity to table the 2004 Budget as it could be in September or even earlier. Then perhaps...just perhaps ...he may relent and give us the much needed cut in the corporate tax rate. We will see.

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Note: The views expressed in the article are the personal views of the author.

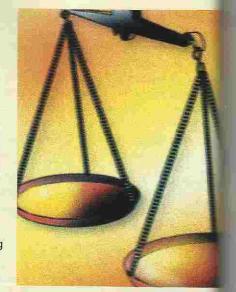
Interesting 2003 Budget proposals at a glance

- Compensation for loss of employment for each completed year of service is now RM6,000.00 (up from RM4,000.00)
- The link dates of 31 December and 1 January for an individual to be resident is no longer required
- 3. I can have more than one private residence and I will not be taxed on them.
- Old folks homes qualify for a 10 year building allowance.
- A Labuan branch of a Malaysian bank will now be taxed under LOBATA, either at 3% of audited net profits or RM20,000.00, upon election.
- Cost of acquiring a foreign owned company to acquire high technology for production in Malaysia or to gain new export markets for local products is given an annual allowance of 20% for 5 years
- A pioneer status company is eligible for reinvestment allowance before expiry of its pioneer holiday if it surrenders its pioneer certificate

- Partnerships or sole proprietors registered with the Registrar of Business which promote the export of certain professional services will also now enjoy the existing double deduction of expenses.
- Tax exemption of statutory income for locally owned manufacturing companies to increase exports
- New, additional or expansion of existing incentives/ pioneer status/investment tax allowances for:
 - · deep sea fishing
 - · food processing activity
 - · modernising chicken and duck rearing system
 - · automotive component modules
 - · selected machinery and equipment
 - · companies moving into knowledge-based
 - · food production companies
 - rubberwood trees planting
 - · conservation of energy

JUDICIAL REVIEW OF TAX CASES

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The concept of fairness imposes a duty on the public decision-maker like the Inland Revenue Board (IRB), to act fairly both procedurally and substantively.

With the extensive appeal proceedings available under the *Income Tax Act 1967* (ITA), it is perhaps unsurprising that the perception of academics and tax practitioners alike is that the scope for judicial review is rather limited. Given the extensive powers conferred on the tax enforcers under the ITA, most taxpayers would rather settle the outstanding tax and penalty and move on with their lives or their business rather than risking a skirmish with the Inland Revenue.

This article advances the proposition that a reasonable balance can be achieved between the extensive powers of the tax enforcers and the fundamental rights of the taxpayers. This can only be done if the constitutional guarantees under the Federal Constitution are brought in to enable the taxpayers to protect some of their fundamental rights in relation to their statutory obligation to pay taxes and to challenge the decisions of the tax enforcers through judicial review. In the UK, human rights issues are increasingly being used in public law and even in commercial matters since the introduction of the UK Human Rights Act 1998. Ironically, similar protection has been available to all Malaysians in Part II of our Federal Constitution since independence in 1957.

This approach is not new in Malaysia and in fact has been upheld by the Court of Appeal in the area of employment to examine the rights of individual employees vis-à-vis the government as an employer in Tan Tek Seng v. Suruhanjaya Perkhidmatan Pendidikan & Anor! and private sector employers in Hong Leong Equipment Sdn Bhd v. Liew Fook Chuan2. Furthermore, the Malaysian courts have ruled that ouster clauses can be overcome if there is an error of law in the case of Syt Kenderaan Melayu Kelantan Bhd v. Transport Workers' Union.3 These cases have collectively raised new areas of constitutional and public law jurisprudence that seriously question the absolute or unfettered discretion of public decision-makers. This article explores the application of the new constitutional jurisprudence to the area of taxation.

It must be emphasized that the modern administrative law concepts of fairness, legitimate expectation, proportionality, illegality and unreasonableness apply equally to taxation matters. The old approach of applying the principles of natural justice is thus widened by these concepts. In Council of Civil Service Union v. Minister of Civil Service⁴, it was held that these categories in

administrative law are not closed and that new factual situations may arise to result in the creation of new categories.

The principle of "fairness"

The concept of fairness imposes a duty on the public decision-maker like the Inland Revenue Board (IRB), to act fairly both procedurally and substantively. Procedural fairness requires that a public decisionmaker must adopt a fair procedure in arriving at a decision. Substantive fairness requires that a public decision-maker arrives at a reasonable decision and ensures that the punishment he imposes is not disproportionate to the wrongdoing complained of. This concept was set out in Tan Tek Seng by Gopal Sri Ram JCA based on Art. 8 of the Federal Constitution which provides the constitutional guarantee that all persons are to be accorded the equal protection of the law.

Examples of unfairness would include decisions which amount to an abuse of discretion, mala fide, or non-exercise of discretion. An examination of decided tax cases in Malaysia will illustrate the point well. For example, in Govt of Malaysia v. Jagdis Singh⁵, the taxpayer was issued additional notices of RM1,000,000.00 based

1 [1995] 1 MLJ 308.

2 [1996] 1 MLJ 481.

1 [1995] 2 MLJ 327.

4 [1985] AC 374.

⁵ [1987] 2 MLJ 185.

on 6000 files with a fee per file of RM600, after the taxpayer filed a report against the tax officer to the Anti-Corruption Agency. The High Court quashed the assessment on the ground of bias:

"With respect I cannot agree that it would be more just for the Applicant to pay over a million dollars of arbitrary assessment to the Government and await the decision of the Tribunal."

Unfortunately, the Supreme Court [as the nighest court was then called eventually overturned the High Court decision and found that the tax officer issued the sessment acting upon the direction of superior and as such, there was no bias. was further held that sec. 91(1) of the IIIA empowered the IRB to compute the according to the best of its judgement.

is observed that the "best judgment" provision for the IRB to impute an sessment appears to confer an element discretion which, in practice, may be itrarily exercised in the sense that there may be no rational basis for arriving at the stimate nor for a decision to deny any Mowance for deduction to the taxpayer.

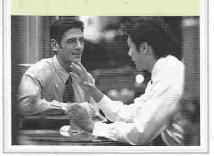
The Supreme Court decision in Jagdis an be contrasted with the Indian case of N Raja Pullaiah v. Dy. CTO, where the ax officer was required by the court to base his best judgment on the taxpayer's business and, not on any others and allowances for deduction must also be taken into account.6 Seen in this light, the outcome in Jagdis may have been different if it had been argued that the duty imposed on the tax officer by Art. 8 of the Federal Constitution to act fairly would not allow the officer to act under dictation by his superior as alleged by him and would in fact require the officer to exercise his discretion in accordance with law.

Another illustration of an erroneous approach is the case of Arumugum Pillai v. Govt of Malaysia7 in the 1970s where Gill CI said,

"The result is that whenever a competent Legislature enacts a law in the exercise of any of its legislative powers, destroying or otherwise depriving a man of his property, the latter is precluded from questioning its reasonableness by invoking Art. 13(1) of the Constitution, however arbitrary the law might palpably be."

Such a statement cannot stand since Raja Azlan Shah FJ (as His Highness then was) in Loh Kooi Choon v. Government of Malaysia8 clearly sets out the principle that the Constitution is supreme and not the Legislature. Therefore, laws must be legislated in accordance with the Constitution and in this case, Art. 8 requires that the laws must be reasonable.

> Under the principle of legitimate expectation, the administration is duty bound in law to comply with the representations or the established practice.



In 1998, the High Court in Bandar Utama v. DGIR 9 imposed a duty on the IRB to give particulars of the assessments and "particulars" was taken by the High Court to mean a detailed account. In fact, this is a mandatory duty as set out in sec. 140(5) of the ITA, the non-compliance of which could render the assessment null and void as having failed the principle of fairness contained in Art. 8 of the Federal Constitution.

The taxpayer in Bandar Utama was alleged to have evaded or avoided liability through accounting irregularities and the underdeclaration of income which would otherwise have been imposed under the ITA. Low Hop Bing J held that as a matter of common sense, the taxpayer must have a right to be furnished with the particulars of the case against them and not just allegations. In arriving at the decision, Low Hop Bing I quoted the following useful passage from the judgment of Lord Denning in the landmark Privy Council case of Surinder Singh Kanda v. Government of the Federation of Malaya10,

"If the right to be heard is to be a real right which is worth anything, it must carry with it a right in the accused man to know the case which is made against him. He must know what evidence has been given and what statements have been made affecting him and then he must be given a fair opportunity to correct or contradict them."

It is submitted that the reasons and basis for the computation must be provided in all assessments and not just sec. 140 tax evasion cases, in order to enable the taxpayer to appeal against the assessment. It seems contrary to accepted principles of natural justice for a person to meet allegations of impropriety without knowing what the nature of the alleged impropriety is.

The doctrine of "legitimate expectation"

The application of the principle of legitimate expectation can best be understood by asking whether the IRB has made any express representations or whether there is any long established practice which the IRB has adhered to. Under the principle of legitimate expectation, the administration is duty bound in law to comply with the representations or the established practice. This principle was extended to its substantive sense in Majlis Perbandaran Pulau Pinang (MPPP)11 to further allow the applicant to claim the substantive benefit or privilege from the administration arising from an expressed representation, in that case, an earlier policy decision by the municipal body.

AIR 1970 AP125.

^{*[1977] 2} MLJ 187. 9 [1998] 7 MLJ 303. [1974] 2 MLJ 29.

^{10 [1962]}MLJ 169 at 172J-173B.

Majlis Perbandaran Pulau Pinang v Syarikat Bekerjasama-sama Serbaguna Sungai Gelugor dengan Tanggungan [1999] 3 MLJ 1.

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The MPPP case also imposed a duty to act fairly by citing Ruddock's case12 and held that legitimate expectation is rooted in fairness citing MFK Underwriting13. The element of fairness within the principle of legitimate expectation is further supported by the case of JPBerthelson v Director General of Immigration14, which cited Denning LJ in Schmidt15,

It all depends on whether he has some right or mterest or, I would add, some legitimate expectation, of which it would not be fair to Eprive him without hearing what he has to say."

This underlying principle of fairness in legitimate expectation can be founded on Art. 8 of the Federal Constitution since the guarantee of equality is derived from the element of fairness as Tan Tek Seng has demonstrated.

In the English case of Preston16, a taxpayer was under investigation by the tax authorities concerning his liability in respect of certain shares that he had sold. He reached an agreement with the tax authorities to the effect that he would withdraw certain claims for tax relief in return for an assurance that no further inquiries would be made in relation to the sale of the shares. Some years later the matter was again brought up by the tax authorities. The taxpayer sought a declaration by way of judicial review that the tax authorities had no right to reopen the matter.

The House of Lords held that the tax authorities could not have bound themselves not to exercise their statutory duty at a future date. However, there was no reason why a taxpayer could not claim judicial review of a decision taken by the tax authorities if that decision was unfair to the appellant where the conduct of the tax authorities is equivalent to a breach of contract or a breach of representation. Such a decision fell within the ambit of an abuse of power for which judicial review is the sole and appropriate remedy¹⁷.

On the facts though, the House of Lords found that the statement by the assessor, "I confirm that I should not wish to trouble you with an interview if you withdraw your claim to relief", had not purported to represent to the taxpayer that they would not reopen the tax assessments if he withdrew his claims. It would appear that the choice of words used in written negotiations or settlements with the IRB is of paramount importance to establish whether there was a legitimate expectation on the part of the taxpayer.

The case of Preston is useful in reminding us that in principle, unfair conduct equivalent to a breach of contract or breach of representation could amount to an abuse of power on the part of the tax authorities.

In essence, the proportionality principle requires public authorities to maintain a sense of proportion between the objective of the legislation and the means that they employ to achieve the objectives of the legislation.



Professor Wade 18 has also commented that the ruling in Preston that unfairness in the purported exercise of power can amount to an abuse of power or excess of power may become an important general doctrine in England and similarly, it is submitted that we cannot ignore this observation in Malaysia either.

In the English case of Unilever's, Unilever's claim to the tax authorities for certain 'loss relief' was time-barred under the relevant law and was accordingly rejected. However, the facts of the case revealed that the tax authorities had made a practice of accepting late claims from Unilever for over 20 years under a special tax submissions procedure developed between the parties as a convenient way of coping with the complexities of Unilever's accounts. The issue which arose was whether the decision of the tax authorities to reject Unilever's claims was lawful, in view of the established practice of accepting late claims by the tax authorities for over twenty years.

The Court of Appeal held that the tax authorities' decision to reject Unilever's claim to be so unfair that it amounted to an abuse of power within the ambit of the principle outlined by Lord Templeman in Preston. Again, this approach when used in Malaysia can be founded on the constitutional guarantee in Art. 8 of the Federal Constitution.

The doctrine of "proportionality"

In essence, the proportionality principle requires public authorities to maintain a sense of proportion between the objective of the legislation and the means that they employ to achieve the objectives of the legislation. In other words, the principle of proportionality is similar in effect to the oft-quoted phrase in criminal law that the punishment must fit the crime. As far as possible, their actions should not infringe on the rights of the individual in order to achieve that aim. The court has the power to weigh the consequences of the administrative action and to quash the action if it is found to be disproportionate based on the peculiar facts of each case. The principle of proportionality which requires fair and just punishment under Art. 5(1) and 8(1) was used in Tan Tek Seng and was also cited with approval by Edgar Joseph Jr FCJ in the Federal Court decision in Rama Chandran 20.

 $^{^{\}rm 12}$ R v Secretary of State for the Home for the Home Dept; ex p Ruddock [1987] 2 All ER 518.

R v Board of Inland Revenue; ex p MFK Underwriting Agencies Ltd & Ors [1990] 1 All ER 91

^{[1987] 1} MU 134

Schmidt & Anor v Secretary of State for Home Affairs [1969] 2

Preston v. IRC [1985] 2 All ER 326.

¹⁷ Ibid., p. 341.

Wade HWR & Forsyth CF, Administrative Law, (7th Ed) at p.419.

R v IRC ex parte Unilever [1994] STC 841.

R Rama Chandran v The Industrial Court of Malaysia & Anor [1997] 1 MLJ 145

There are certain powers within the IRB's considerable arsenal that may offend the principle of proportionality and Art. 8 of the Federal Constitution particularly, in situations where the taxpayer disagrees with a tax assessment made. The obvious powers are the very intrusive powers for search and seizure. There are however, several 'silent' provisions under the ITA read together with, for example, the National Land Code 1965, that could give rise to disproportionate actions by the IRB. Under sec. 103 and 103A of the ITA, any tax payable under an assessment shall be due and payable, whether or not that person appeals against the assessment. As the facts in Jagdis has shown, such an assessment may be a mere estimate.

Under sec. 320(1)(ba) of the National Land Code 1965, a Registrar's caveat may be entered in respect of any land:

"for securing that the land will be available to satisfy the whole or part of any debt due to the Federation or the State Authority, whether such debt is secured or unsecured and whether or not judgment thereon has been obtained".

After obtaining a judgment against the taxpayer, the IRB can direct the Registrar under the National Land Code to enter a Registrar's caveat against any landed property belonging to the taxpayer21. In such a situation, the taxpayer may find it difficult to appeal against the judgment per se. But the question is whether the action of the IRB is disproportionate and ought to be the subject of judicial review? Firstly, the taxpayer may have to invoke its rights under Art. 8 of the Federal Constitution on the basis that the assessment was unlawful since it may have been issued arbitrarily. Secondly, Art. 13 of the Federal Constitution may be resorted to in asserting that no person shall be deprived of his or her property save in accordance with the law, in order to free the land from the encumbrance imposed by the Registrar's caveat.

Illegality

The concept of legality requires the public decision-maker to exercise its powers appropriately. Where it is clear that the IRB has acted outside the boundaries of the clear provisions of the ITA, the IRB's decision should be struck down for illegality. An example of where the IRB misapplied the criteria under the ITA is

the case of The Board of Trustees of the Sabah Foundation v. Director-General of Inland Revenue²².

In granting the order sought by the Applicant, Charles Ho J, cited Rama Chandran and also made reference to the Federal Court case of Pengarah Tanah dan Galian, Wilayah Persekutuan v. Sri Lempah Enterprise Sdn Bhd²³ where Raja Azlan Shah FJ (as His Highness then was) expressed as follows:-

"Unfettered discretion is a contradiction in terms... It does not seem to be realized that this argument is fallacious. Every legal power must have legal limits, otherwise there is dictatorship... In other words, every discretion cannot be free from legal restraint; where it is wrongly exercised, it becomes the duty of the courts to intervene. The courts are the only defence of the liberty of the subject against departmental aggression."

Generally, courts do not accept the concept of an absolute or unfettered discretion. In exercising its powers, the IRB must have a basis for its conclusion and must not fail to recognise the legal treatment of the ITA provisions and the width of its powers must be properly construed.

In other words, there must be a legal basis for the IRB's treatment and conclusion in order for the IRB to have discharged its duty under the Federal Constitution in ensuring that the taxpayers are given lawful treatment under Art. 8.

Versions of "unreasonableness"

In *Tan Tek Seng*, the principle of reasonableness is an essential element of equality or non-arbitrariness which pervades Art. 8 "like a brooding omnipresence". The principle of reasonableness as envisaged by Art. 8(1) appears to be more flexible than the *Wednesbury*²⁴ unreasonableness. Article 8(1) requires the decision to measure up to the standard of reasonableness in order to stand whilst *Wednesbury* unreasonableness allows a decision to stay unless it meets the standard of unreasonableness ²⁵.

In Sarawak Shell²⁶, a case involving service tax, it was held that the "Malaysian courts have been quick to prevent attempts to read words into taxing statutes to the disadvantage of the taxpayers." It went on to cite the 'Wednesbury principle', as applied and expanded by the Supreme

Court in the Kumpulan Perangsang Selangor²⁷ case, where it was decided that when a decision was challenged on the grounds of Wednesbury unreasonableness, the court is not confined to an examination of the decision-making process but could examine the merits of the decision itself.

The High Court held that the respondent had acted in excess of his jurisdiction and unreasonably in accordance with the Wednesbury principle in deciding that the applicants were subject to service tax in rendering services under production sharing contracts. This was because the enabling provision i.e. sec. 728 of the Service Tax Act (STA), only operates where there is a distinct business of providing taxable service29 and not where the service (management services30 in the instant case) is a component feature of some other business such as the oil and gas business. Article 8 of the Federal Constitution can be brought in to require reasonableness in such cases.

Judicial Review versus appeal procedures in the ITA

Where a statute provides for a specialised appeal procedure as in the ITA under sec. 99, the courts generally would not grant judicial review. However, this is always subject to the grant of review in certain cases, for example, where an applicant is able to demonstrate excess or abuse of power, or breach of the rules of natural justice (Napier31; Gillock32). Professor Wade reckoned that the reality of the matter is that when genuine grounds for judicial review are alleged, it is the refusal rather than the grant of relief which is the exceptional course33. Illegality or unlawful treatment should also safely fall within this criteria.

As Lord Denning MR observed in *Kharrazi*³⁴ citing *Royco Homes*³⁵, where an immigration officer's decision refusing the applicant permission to enter the UK was quashed, that it has been held on countless occasions that the availability of appeal does not debar the court from quashing an order by certiorari and that everything depends upon the facts of the case.

It is important to note that in many instances, the taxpayer who is aggrieved or adversely affected by the decision of the IRB may not be able to appeal under sec. 99 of the ITA because appeals under

sec. 99 are limited to cases where an assessment notice has been issued. Yet any tax practitioner knows that taxes are also paid in instances where no notice of assessment may be issued for example in withholding tax cases. The tax position of a taxpayer may also be adversely affected by adjustments in capital allowances where no assessment would be issued since there is no tax liability as in Enesty Sdn Bhd v. Ketua Pengarah Jabatan Hasil Dalam Negeri36. Status of taxpayers wrongly determined by the IRB may also adversely affect the tax position of the taxpayers in applications for tax exemption.

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On this point, the MPPP case is useful since it deals with a similar appellate provision in the Town and Country Planning Act 1976. It was held that if an applicant in judicial review proceedings can demonstrate illegality or any breach of public law principles, it would be wrong to insist that he exhausts his statutory right of appeal simply because there is one available. The taxpayer should not be Lenied the quicker, more convenient and adequate remedy of judicial review especially where it concerns public interest in arriving at the correct interpretation of the tax laws.

Powers of the Court and moulding of relief

In judicial review proceedings, the court mends to confine itself to reviewing the decision-making process and not the decision itself. It has been difficult for an aggrieved person or adversely affected person to seek justice even where the decision taken is grossly unfair or unreasonable.

This approach has been changed somewhat with the case of Rama

Chandran, where it was held that the court is empowered to review the decision for process and substance, substitute the impugned decision with its own and to mould the relief sought by the aggrieved person. Although this remedy should only be granted where the factual matrix of the case requires it, it is good to bear in mind that this remedy should nevertheless be made available in tax cases where grave hardship may be caused to the taxpayer concerned. This power of the court is found under sec. 25 of the Courts of Judicature Act 1964 read with para 1 of the Schedule. Paragraph 1 of the Schedule reads as follows:-

"Power to issue to any person or authority directions, orders, mandamus, prohibition, quo warranto and certiorari, or any others, for the enforcement of the rights conferred by Part II of the Constitution, or any of them or for any purpose."

Much guidance has been taken by the Malaysian court from several Indian Supreme Court decisions on the interpretation of Art. 226 of the Indian Constitution which is in pari materia with para 1 of the Schedule.

In India, the courts have adopted a liberal and activist approach in protecting the fundamental rights of the taxpayer in carrying out its judicial duties. In the tax case of Pooran Mal 37, that dealt with search and seizure, it was alleged that the Director of Inspection could have no possible reason to believe that there were grounds to issue the authorization for a search as laid down in sec. 132 of the Indian Income Tax Act. The court in its determination of the issue, exercised its powers under our equivalent para 1 of the Schedule by calling for the tax department file in order to satisfy itself whether or not there were grounds for the search. We may hope that the time may come when our judges would do the same to protect the fundamental rights of the people under the Federal Constitution.

The need for transparency

"... Tax practitioners must avoid the literal interpretation of existing legislative or judicial compromises enshrined in the law as immutable or rendered just by their very existence... 38 ".

A tax system can be judged from different points of view. Is the system fair? Does it contribute as much as possible to the growth and stability of the economy? Are the rights and liberties of the individual protected?39 The focus in tax discussions will inevitably shift from the sort of technical and narrow statutory interpretation which decide current tax cases towards the control and conscious structuring of discretion in public administration.

The objective of the tax authorities should not be to collect as much tax as possible regardless of the intention of the law (for example, in the areas of interest restriction and withholding taxes, where the court interpretation of the ITA favourable to the taxpayer should not be dismissed) but to collect tax only where it has been lawfully and unambiguously imposed. As in the English tax case of Vestey40, it has been said that one should be taxed by law and not be untaxed by concession, say via guidelines or rulings. Such practice is arbitrary, unjust and unconstitutional against Art. 8 of the Federal Constitution.

There must be an awareness that the IRB has a constitutional obligation to act fairly and reasonably in discharging its statutory duty to collect taxes. In so doing it cannot act arbitrarily or disproportionately impose tax obligations on taxpayers. A responsible approach to tax collection will enhance the tremendous effort put in by the government to devise tax incentives among other things to make Malaysia competitive in the world regime with the imminent arrival of the WTO and globalisation.

Lucy Chang Ngee Weng Advocate & Solicitor Azman Davidson & Co.

For an example of some problems posed by Registrar's caveat, see Development & Commercial Bank Bhd v. Land Administrator Wilayah Persekutuan & Anor [1991] 2 CLJ 1092. Originating Motion No. K7 of 1991Decision dated 28. September 2001 unreported)

(1979)1 MLJ 135 at 148

Associated Picture Houses Ltd v. Wednesbury Corp [1948]1 KB

Pillay, Sudha CKG, 'Towards a Re-Formation of Wednesbury Unreasonableness in Malaysia' [2000] 4 MLJ cxxi.

Sarawak Shell Bhd v. Menteri Kewangan [2001] 1 MLJ 602 at p. 622.

Kumpulan Perangsang Selangor Bhd v. Zaid bin Hj Mohd Noh [1997]1 MLJ 789.

s.7- subject to this Act, service tax shall be charged on and paid by any person who carries on the business of providing taxable service referred to in s 3(a) or selling or providing taxable goods referred to in s 3 (b).

Taxable Service' is exhaustively set out in the schedules of

subsidiary legislation passed under the STA.

In this case the prescribed services under the Service Tax Regulations 1975 involve Item 28 on 'provision of all types of management services including project management and project coordination', and the prescribed professional establishment concerned is in item 17, 'companies, firms and sole proprietors providing management services, excluding companies, firms and sole proprietors providing management services and having annual sales turnovers of less than RM300,000 of prescribed service'

R v Commissioner for the Special Purposes of the Income Tax

Act; ex parte Napier [1988] 3 All ER 166. Accountant in bankruptcy v. Alls of Gillock [1991] SLT 765. see Wade and Forsyth, Judicial Review of Administrative Action (7" Ed) p 725.

R V Chief Immigration Officer Gatwick Airport; ex parte Kharrazi [1980] 3 All ER 373 at p 380.

R v Hillingdon London Borough Council; ex parte Royco Homes Ltd [1974] OB 720.

[1997] 5 MLJ 104.

Pooran Mal v Director of Inspection (1974) 93 ITR 505. Baxt R (et. al) Cases and materials on Taxation, (2 Ed, 1984)

Canadian Royal Commission on Taxation Report (1966) Vols 1,3, in Baxt (et al) op cit p 17.

(1980) AC 1148.

Tax Rates and the Laffer Curve

Income tax is seen to have such a great effect on the motivations of business because of its direct implications on the bottom line.

By Kenneth Yong

YEAR 2002 saw the month of September herald in yet another national budget. The eager anticipation surrounding the development and unveiling of Budget 2003 was fed by provisional intelligent guesses of expected changes, and early consensus forecasts as to how the economy and livelihoods of all citizens (individuals and corporations alike) would be affected in the next twelve months. While all aspects of the budget announcement would have some degree of economic implication, of more specific concern to the business community was the anticipated (perhaps even expected) adjustments to policies on taxation.

More than any other budget element, taxation policies can potentially draw on a huge influx of business and investment into the country, or initiate massive exodus of business funds to our neighbours. Thus, a carefully crafted taxation policy is crucial to the economic development of a country.

Numerous aspects of tax policies can be tinkered and tweaked, many of which are of little concern to most businesses, but one key item hardly escapes close scrutiny and attention: the income tax rate. Most companies will recognise this as the "allencapsulating" rate of tax which applies mercilessly to their bottom line figures. In fact, the income tax rate forms the focus of rife speculation and interest among industry watchers.

The past decade has witnessed the gradual decline of the income tax rate on companies from 40% (YA 1988 and prior) to 28% (YA 1998 onwards), with an average rate reduction of approximately 2% every two years. A simple extrapolation of this trend would suggest further rate drops are imminent, but this piece of statistics has stubbornly refused to materialise over the past five years, and Budget 2003 propagated this trend. Even the eager anticipation of a rate reduction (that many industry watchers felt was long overdue) failed to convince policy setters to genuinely dislodge corporate tax rates from its 5-year 28% perch.

Income tax and business

Income tax is seen to have such a great effect on the motivations of business because of its direct implications on the bottom line. By all accounts, tax can be a substantial "expense" item on the income statement, drawing away over a quarter of what would have been available to equity shareholders. Furthermore, the tax expense necessitates prompt monthly cash payments to the Inland Revenue Board who frequently penalise errant taxpayers that fail to comply with the timely tax schedules.

In addition, the presence of taxation will almost certainly "worsen" financial performance indicators such as the net

profit margin and return on equity (through reduced net income after tax), as well as liquidity and gearing ratios (through higher tax provisions and deferred tax liabilities). If we want to look for a defining moment that demonstrates this effect, we need travel no further back in time than to the tax waiver year of 1999. It is arguably true that the absence (or significant reduction) of taxation from the income statement and reduction of tax liability in the balance sheet of year 1999 had generally improved the financial statements of many companies which were just recovering from the economic battering endured in the late 1990s.

However, the negative effects mentioned above merely present the direct implications of taxation on a microeconomic view. Although less obvious, an equally profound effect of taxation is its role in influencing productivity. This is aptly illustrated below.

Work versus productivity

Let us create a hypothetical economy where income tax is absent. Our subject of observation, Mr. X, a resident of this simulated economy, works hard daily to accumulate wealth. In this tax-free environment, the fruits of Mr. X's labour are entirely his, and the daily hours he puts in from 9 to 5 are sufficient to achieve his desired financial target.

Now, consider the sudden intrusion of income taxes in this once tax-free economy. Mr. X no longer takes home all his earnings; part of it is compulsorily channelled away as income taxes, and what balance remains is no longer sufficient for him to achieve his financial target. Instinctively, Mr. X decides to increase his after-tax income by working longer hours until he eventually regains an after-tax income which equals his former income in the zero-tax economy. Mr. X misses his favourite television program and perhaps reschedules his evening walks but this is a small sacrifice which he can tolerate.

Subsequently, the income tax rates are further increased, and Mr. X once again finds his after-tax income dwindling below his required financial target. Again, he opts to work even longer hours (in addition to the already existing overtime driven by the first tax introduction) in the hope of re-attaining his former income from the zero-tax economy. Mr. X sacrifices rest time and attempts to push his already exhausted mind and physique beyond normal operating parameters, which impairs his work performance even during normal work hours. In short, his overall productivity declines (he suffers from the syndrome of diminishing marginal returns), and he loses incentive to work hard.

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Some important observations can be drawn from the above - people do not work to pay taxes, they work for after-tax income. When tax rates are raised, there is a tendency to work harder and longer to maintain after-tax income, but the effects of diminishing marginal returns will set in and drain their productivity. Hence, more work is not equivalent to more productivity. Only the latter contributes to a country's output.

Incentive to work and tax evasion

Continuing our Mr. X simulation, what would happen if tax rates are raised even further? Mr. X comes to a powerful realisation that it would be impractical (and perhaps impossible) for him to work harder and longer for his financial target because the drastic decline in productivity from long hard work renders his financial target unachievable. Thus, he loses the incentive to work, abandons the philosophy of working hard, and spends a great deal of time searching for schemes to evade the high taxes. Clearly, the ultimate loser in this economic simulation is the economy itself because it has lost out on the contributions that could have been derived by Mr. X's potential effort.

The Mr.X-analogy is equally applicable to machines, companies, and ultimately, the entire economy as all are vulnerable to the effects of diminishing marginal returns: extending operating hours of machines will cause them to malfunction and require more frequent repairs; stretching the activities of companies beyond a certain limit will induce rising productioncost-per-unit. If all the people, machines and companies were infected by the plague of diminishing marginal returns brought on by high taxes, the economy itself would be under productive. Therefore, the moral of the Mr.X-story appears to be: taxes tend to stifle productivity of an economy, destroys the incentive to work and eventually, induces the search for tax evasion.

The taxing government

Why do taxes continue to be imposed? The reason lies in the fact that the economy requires two types of goods: private goods (which can be provided by businesses in the economy) and public goods (which cannot be provided at affordable prices). Thus, taxes can represent the "price" paid for the public goods supplied by an economy, and the government acts as the supplier of such public goods. In order to provide a plentiful supply of public goods, the government attempts to collect as much taxes as possible. Very often, this is achieved by increasing the income tax rate. Simple mathematics reveals that the tax revenue is the product of the tax rate and the size of the tax base; static analysis would then imply that increasing the tax rate should increase the tax revenue.

However, history has revealed that economic systems are rarely (if at all) perfectly simple and predictable. Increasing the tax rate would lead to increased tax revenues only if the tax base did not shrink to offset the hike in rates. Unfortunately, our former visit to Mr. X in the simulated economy has clearly demonstrated that increasing taxes tends to stifle productivity as well as destroy the incentive to work, and thus can potentially reduce the tax base! For governments to increase tax revenues, they must correctly anticipate the quantitative effect that the tax hike will have on the tax base, and this by all accounts, represents an extremely difficult forecast.

The Laffer Curve

The points explained in the preceding paragraphs are well embedded in the work of Arthur Laffer (Professor of Business Economics at University of Southern California) who developed the "Laffer Curve" - a beautiful geometric portraval of the behaviour of tax revenues and tax rates.

The "Laffer Curve" illustrated in Figure 1 is a simple curve which depicts the relationship between tax rates and tax revenues. The message behind the curve too, is simple enough - though, like so many simple points, it is also powerful in its implications, one of the most profound is that reducing tax rates can increase the government's tax collections.

Shown on the horizontal axis of the Laffer Curve is the tax rate (the independent variable), while the vertical axis is the tax revenues (the dependent variable). The curve intersects the horizontal axis at two points - 0% and 100% tax rates - and the economic reasoning for this is quite obvious. At 0% tax rate, the government would collect nothing, even though the economy is maximising production and output is only limited by the desire of workers for leisure. Nonetheless, the government treasuries would be empty at 0% tax rate.

Similarly, at 100% tax rate, the government can expect zero tax collections because there would be no incentive to work (people would not work if all their rewards are confiscated by the government). This will induce a shift of economic activity from the money economy to either the barter economy or to the illegal "black" market economy (which exists largely to escape taxation in the first place).

Properties of the Laffer Curve

We are now able to explain two points on the curve: at 0% tax rate, the economy is at maximum activity (but tax collections are zero) and at 100% tax rate, the economy is functioning entirely through barter and illegal trade (and tax revenues are again zero). In between, lies the mysterious curve.

The Laffer Curve suggests that as tax rates are moved from 0% to 100%, the curve initially slopes upwards (showing an increase in tax revenues), reaches a "peak", and takes a descent back toward the horizontal axis (showing a decrease in tax revenues). What is the reasoning behind the shape of the curve, and how can we be sure the shape is reasonable (if not exact)?

To test for the reasonableness of the shape of the Laffer Curve, we can apply a mathematical theorem called Rolle's Theorem which roughly states that if a continuous curve cuts the horizontal axis twice, it should have a turning point, or a "peak" somewhere in between the crossings. The previous paragraph has already established the two points (0% and 100%) where we witness the crossings along the horizontal axis. Hence, there must be a "peak" on the Laffer Curve where the tax revenues are maximum (Point B in Figure 1). This idea behind the Laffer Curve will surely entice any government who will wish to maximise tax collections in its treasury by seeking out this magical tax rate.

The tax rate that results in the peak in revenues, which we will refer to as the "optimal tax rate" (Point B in Figure 1), does not necessarily occur at 50% tax rate (although it could by coincidence). Instead, it is a variable whose range of occurrence is anywhere between 0% and 100% tax rate, and will differ from country to country and even from year to year. We now explore what is the reasoning behind the shape of the Laffer Curve (as this will give a hint to where the optimal tax rate lies).

Two forces are at work in giving the Laffer Curve its shape: the tax rate effect, and the tax base effect. The tax rate effect is purely numerical, and causes tax revenue to rise as a result of a higher tax rate. Thus, the tax rate effect expands tax revenues when tax rates rise.

The tax base effect is more interesting. The relationship between the tax rate and the tax base is depicted in Figure 2 which shows that as tax rates are increased, the tax base shrinks. Furthermore, when tax rates are very low, the tax base is not sensitive to changes in tax rate. However, at higher tax rates, the tax base becomes more sensitive to changes in tax rates. Thus, the tax base effect contracts tax revenues as tax rates rise.

Combining the tax rate effect and the tax base effect, we find that at low rates (such as Point A in Figure 1), the reduction in the tax base is sufficiently offset by the increase in rates, yielding a net increase in revenue. We can view this as the "inelastic" stage for tax revenues (borrowing the term from the economic concept of price elasticity). At very high values of tax rates (such as Point C in Figure 1), any small increase in rates would trigger a relatively large reduction in the tax base, resulting in a net decrease in tax revenues. This can be viewed as the "elastic" stage for tax revenues.

Somewhere in between, there is a precise tax rate at which the tax rate effect (which expands tax revenues) and tax base effect (which contracts tax revenues) will be balanced, and this is the "optimal tax rate" (Point B in Figure 1) where tax revenues are maximised.

The "optimal tax rate" not only allows governments to maximise their tax collections, but also represents the point where the transition from the "inelastic" stage to the "elastic" stage occurs, and thus has profound implications for economic policy. In the "inelastic" stage, raising the tax rate can increase tax revenues, but in the "elastic" stage, raising rates will have the opposite effect. The key is to determine which point or stage the economy is presently at. This is in fact very difficult in practice.

As indicated earlier, the "optimal tax rate" is not a static and consistent rate, but instead, changes from year to year. An economic interpretation is that the optimal tax rate is the rate at which the economy as a whole "desires" to be taxed. When the economy desires more public goods, it is willing to be taxed at higher rates (causing the tax base effect to become weaker); hence, the optimal tax rate takes a higher numerical value. Difficult as it is to fathom, this actually happens when a nation demands more public goods such as military defense. At the siege of Leningrad in World War II, the people of the city worked for 900 days at tax rates approaching 100% to prevent their city from being taken over. However, at times of peace, the demand for public goods such as military goods and services from the government will fall sharply, and the economy will desire to be taxed at a lower rate.

Dual rates single tax revenue

Another powerful idea behind the Laffer Curve is that there are two tax rates that yield the same tax revenue - one to the left (Point A) of the "optimal tax rate" and one to the right (Point C). That being the case, it would seem logical to stay at the "inelastic" portion of the curve (ie. Point A) to reduce the burden on the private sector (productivity and incentive to work are destroyed at high tax rates), and more importantly, to curb the shift from the money economy to the "black" market economy. In "Wealth of Nations", Adam Smith highlighted that the prevention of tax evasion (which is more rampant at higher tax rates) requires a great number of compliance officers whose salaries may eat up a greater part of the tax collections, and the frequent compliance checks by tax officers will discourage business in general. Thus, high tax rates (Point C) should be avoided. Furthermore, choosing a lower tax rate will most certainly buy more election votes as tax reduction is a powerful political sell point.

The ideal tax rate in Malaysia

Malaysian companies have been taxed at 28% since YA 1998, and this tax rate has stubbornly remained unchanged up to YA 2002. Budget 2003 attempted to grant a

FIGURE 1 - THE LAFFER CURVE

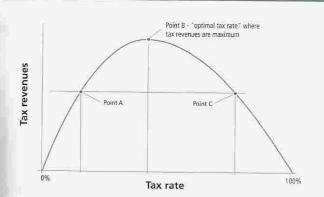
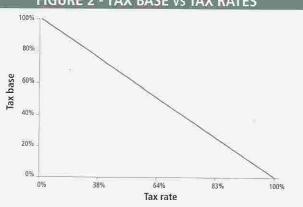


FIGURE 2 - TAX BASE vs TAX RATES



partial tax reduction by introducing a 2tier tax rate of 20% on the first RM100,000 of chargeable income for small and medium scale companies, but apart from this, failed to offer any broadbased tax reduction below 28%. Could the government's affinity towards 28% be an indication that this is the "optimal tax rate" that maximises tax revenues for Malaysia? Insufficient publicly available research has been conducted in Malaysia no provide adequate insight into this question. However, it is interesting to note that Professor Laffer had suggested that the "optimal tax rate" is a flat rate of about 30%! Malaysia's current corporate tax of 28% stands close to the revenue maximisation rate envisaged by Laffer.

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However, direct comparisons of this sort are premature. Firstly, Laffer's original research is now somewhat dated, and his focus was on the US economy, not developing countries like Malaysia. Furthermore, Malaysia offers a handful of other tax-incentives (e.g. pioneer status, investment tax allowance, reinvestment allowance etc.) which go a long way in helping targeted companies decrease their effective tax rates substantially below 28%. If these incentives were factored into the Laffer Curve analysis, the "average" tax rate of Malaysian companies would be lower than what the statutory rate alone would suggest. As revealed during Budget 2003, the manufacturing sector has enjoyed tax exemptions which bring the effective tax rate down to about 8%, a mere fraction of the full 28%.

Which raises the next question: since Malaysia's average corporate tax rate is clearly below the "optimal" 30%, would the Laffer Curve analysis suggest that increasing corporate tax rates in Malaysia will increase tax revenues? Perhaps. And no doubt a prospect that a budget-deficit government would have considered while crafting Budget 2003. But the Laffer Curve

analysis merely provides a model to explain the relationships between tax rates and tax revenues. It is not a prescription for economic policy. Macro economic policies have other considerations which are not entirely based on maximising tax revenue, and this limits the use of the Laffer Curve as a policy-setting tool.

In the past decade, one of the most frequently mentioned business buzz word must have been globalisation. As businesses from developed and developing countries alike invest abroad to diversify their economic and business risk, they seek countries which provide good after-tax returns. Thus, a low tax rate is a crucial factor which will give a prospective country a greater international appeal in drawing foreign direct investments (FDI). Furthermore, if corporate tax rates of our neighbouring countries continue to tumble (e.g. Singapore's pre-announced 2% tax cuts for future years), and with the almost hypnotic allure of China as a business hot spot, the case for a low corporate tax rate to retain existing business within Malaysian shores becomes a real issue for concern.

Ultimately, globalisation compels all business to be more efficient and more competitive. Governments too are not spared. As countries shift into high efficiency, so must their governments. Public spending needs to be rationalised. Operating costs of the public sector must be tightened to increase efficiencies with the view of reducing the burden on the private sector. After all, if corporate tax rates could be reduced sufficiently, FDI inflows into Malaysia would certainly create more employment, expanding the tax base (for corporations as well as for individuals) from which tax collections could again be enhanced through Laffer-type effects in secondary tax bases such as individuals. Ultimately, shouldn't full employment take priority over tax maximisation?

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Beginning 2001, the IRB introduced the self-assessment system. Under this system, taxpayers are required to compute their own tax liability but retain adequate accounting records and tax working papers for subsequent tax audit, by the Inland Revenue Board (IRB).

As with any tax system, taxpayers are normally at a loss to comply with tax laws and will need all the assistance they can get from the tax professionals. But assisting the unwary taxpayer has now become a very difficult task.

There is a sense of uneasiness among tax professionals under the self-assessment regime, particularly so with the introduction of audit surveillance. This apprehension is caused chiefly by the introduction of the amended sec. 114(1A) of the *Income Tax Act 1967* (as amended) (ITA).

Section 114(1A) of the ITA, reads as follows:

"Any person who assists in, or advises with respect to the preparation of any return where the return results in an understatement of the liability for tax of another person shall, unless he satisfies the court that the assistance or advice was given with reasonable care, shall be guilty of an offence and shall, on conviction, be liable to a fine not less than two thousand ringgit and not more than twenty thousand ringgit or to an imprisonment for a term not exceeding three years or both."

The crux of the amended sec. is the concept of "reasonable care".

This article will look into the concept of reasonable care and its impact on the taxpayer and the tax professional.

Public Ruling No. 8 of 2000 - Wilful Evasion Of Tax And Related Offences

In order to understand the implication of the amended sec. 114(1A), one need to understand the earlier sec. 114 which provides for the following:

 a) Any person who wilfully and with intent to evade or assist any other person to evade tax;

Reasonable care under self-assessment

By Nakha Ratnam Somasundaram

- b) Omits from a return made under this Act any income, which should be included;
- Makes a false statement or entry in a return made under this Act;
- d) Gives a false answer (orally or in writing) to a question asked or request for information made in pursuance of this Act;
- e) Prepares or maintains or authorises the preparation or maintenance of false books of accounts or other false records;
- f) Falsifies or authorises the falsification of books or accounts or other records, or;
- g) Makes use or authorises the use of any fraud, art or contrivance.

shall be guilty of an offence.

In view of the seriousness of the above section, the IRB has issued a Public Ruling to explain and provide some guideline on the interpretation of sec. 114 as well as sec. 114(1A)¹. As this is a very important Public Ruling, the following paragraphs will examine the contents of this Ruling.

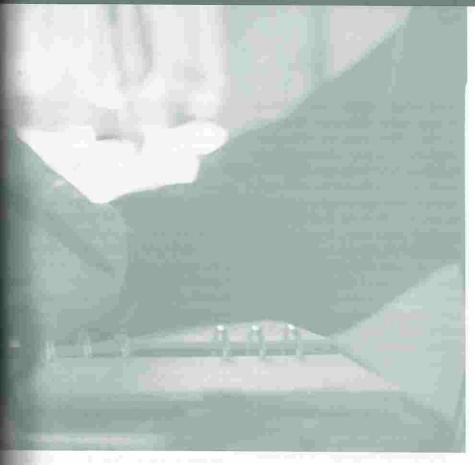
In sec. 114 there is a presumption that in an instance of false statement, or deliberate omission of any entry by any person, then that person is presumed to have made the false statement or false entry or both with the intention to evade tax. The onus is on the taxpayer to prove that it is not so.

Wilful evasion of tax is interpreted in the ruling to mean any action or deed deliberately performed or done with the purpose or intention of evading or assisting any other person to evade tax. This will include any one or all of the following:

- a) Deliberate omission of any income from a return;
- b) Making a false statement or entry in a return;
- c) Giving a false answer (whether oral or written);
- d) Preparing and/or maintaining false books of accounts or other records;
- e) Authorising the preparation and/or the maintenance of false books; or
- f) Use of fraud or authorising the use of fraud in record keeping.

Assistance in or advice with respect to the preparation of a return

The ruling explains that where a person assists in or advises with respect to the preparation of a return and as a result of that assistance or advice, there is an understatement of the liability for tax of another person, the person giving the assistance or advice may be liable for prosecution.



Significance of the Director General's Public Ruling

The ITA has many sections, which are rague, too broad or not clear, and is the whicet of varying interpretation - often referred to as the "grey area". The latest the series of grey areas is the taxability interest - whether it should be taxed under 4(a) as business income or under 4 d) as interest income - as for example, in the case of a business that deals with commodities, investing excess funds in a fixed deposit with a bank. The IRB has always maintained that this income is interest per se. It took the Malaysian court almost 35 years to determine interest ncome could be treated as business moome in certain cases2.

Although the facts of each case are ifferent, nevertheless, such ambiguous reas can cause problems to the smooth implementation of the self-assessment stem. Hence the IRB issues a Public Buling to provide guidelines for the public s well as the IRB officers. It projects the ficial stand of the Director General DG) on the relevant technical matter, the policy and the procedures that are to be applied to the subject matter.

Is the Ruling binding in law? The IRB Public Rulings have no force in law because no enabling law exists giving it any status similar to a statute passed by Parliament that binds the citizens of a country. The Ruling therefore reverts for its authority to the legislation that underlies it. For example, a ruling on evasion will revert to sec. 114 of the ITA for its effect.

Under the self-assessment system, the taxpayer is mandated to inform whether they have complied with all the Public Rulings. The new Return Form C for example, has a ominous box in the first page itself, asking upfront whether the IRB Public Rulings have been complied with or not. If you indicate that you have not, then what is the consequence to the taxpayer and the tax professional who may have assisted the taxpayer to prepare the return? There is some speculation, that it is almost certain that such a disclosure is an invitation to the IRB to conduct a field audit on the taxpayer.

Reasonable care

If a taxpayer has exercised reasonable care then he has complied with the requirement of the law. Under the selfassessment system, assistance or advice is treated as given with reasonable care if it is done on the basis of:

a) A proper interpretation of the Income Tax Act 1967 (as amended);

- b) A decision of any case law;
- c) Any ruling issued by the IRB;
- d) An interpretation which is reasonable;
- e) The person has acted in good faith;
- f) Has taken all necessary action expected of a reasonable person.

In such an instance, the presumption of the intention to evade will not be made.

If not, a presumption exists. It then becomes rather cumbersome and difficult to rebut the presumption of wilful evasion. For example, how do you prove that you had good faith (and all good intentions) when you filled in the Form C?

The Ruling gives seven (7) examples where a person may be considered for prosecution for wilfully evading tax. It may range from omission of income, final accounts prepared from estimated and fictitious figures, claims not supported by proper documents to errors and mistakes etc.

In most instances, the problem faced by a tax professional is non-disclosure by a person on whose behalf the return is prepared or more commonly, a mistake or error in the return.

Reference is made in this article to two (2) examples contained in the IRB Public Ruling No 8 of 2000.

EXAMPLE 1

Non-disclosure by a person on whose behalf a return is prepared

A tax agent completes a return on behalf of an individual, who has verbally confirmed that his wife has no income. After the Return Form has been signed by the individual, it is dispatched on his behalf by the tax agent. The rent of RM12,000 received by the wife is not included in the return, as this has NOT been disclosed to the tax agent.

The individual or his wife may be liable for prosecution for evasion of tax by deliberate omission of income in the return. No action will therefore be taken against the tax agent because no dishonest intention should be drawn against him.

EXAMPLE 2 Mistake or error

A tax consultancy firm is engaged to complete a return on behalf of a company. The tax computation indicating a tax liability of RM144,144 and the duly completed are submitted by the company for review and approval. The return is later furnished to the IRB on behalf of the company. In the tax return, the figure is shown erroneously as RM141,414. The settlement of the tax liability is made by the company on the basis of the correct figure. The understatement is not detected, till two years later, when a tax audit is carried out.

Since the correct amount of tax has been paid, despite the error, no action will be taken, either against the company or the tax agent, because there will be no inference of a dishonest intention

If the tax paid had been made on the basis of the incorrect figure, then action may be considered against the company on the basis of sec. 113 for making an incorrect return.

If such errors occur frequently, and there is indication that they are not innocent errors. then action may be taken against the tax consultancy firm under sec. 114(1A).

In the ruling, reasonable care is interpreted to "mean the degree of care or conscientiousness in paying proper attention to a task that is expected, in a similar situation, of an ordinary person who, considering the circumstances and the foreseeable consequences, acts with reason, sound judgement and responsibility."

Proving that one has acted with reasonable care is not an easy matter. In an Australian case,3 a taxpayer who was an employed person, as a consequence of an inheritance, had placed money in an interest bearing time deposit. The bank provided with relevant statements and notices of interest earned at the relevant financial year. The taxpayer had retained a tax agent to prepare her tax returns. She will bring all the relevant documents and paper relating to her income to the tax agent to prepare the tax return. In due course, the return of income for the financial year 1997 was presented to her for signature. She did not read through the return nor verified the various entries. She

merely signed the return, trusting that the tax agent knows what to do. The return was duly filed. The tax office later discovered a discrepancy (arising from the negligence of her former tax agents) and raised additional taxes and a penalty was imposed. Taxpayer objected to the penalty on grounds that she had exercised reasonable care.

The taxpayer maintained that the allegation of lack of reasonable care is unjustified. Her contention was that she had paid an accountant professional fee to do her tax. As she is not familiar with the tax calculations, she had trusted him and signed the documents believing them to be true. She claimed that she should not be penalised for a mistake done by her tax agent.

The Australian tax office quoted their Tax Ruling No. 94/4 to say that "a reasonable care test requires a taxpayer to take the care that a reasonable, ordinary person would take in all the circumstances to fulfil the tax obligation..."4 Further it went on to say that a taxpayer does not satisfy his or her obligation to take reasonable care simply by using the services of a tax agent or other tax advisors5.

The Administrative Appeals Tribunal heard her case. A decision was given against her. However, a remedy is available to the taxpayer to make a claim against her tax agent to recover damages.

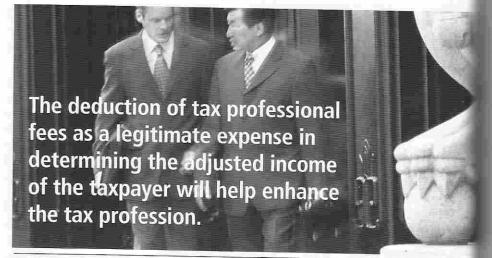
Given the same facts as in the above Australian case, if the appeal had been heard in Malaysia, would the Special Commissioners or a Malaysian court have treated this as assistance given with a view to understating the tax liability and therefore find the tax agent guilty of an offence (instead of the taxpayer)? Or would it be treated as an error or mistake (and therefore there would be no presumption to evade tax)? Would a negligent act by the tax professional be deemed an intention to evade tax, or merely not having exercised reasonable care? What is the implication to the taxpayer - has she exercised reasonable care in the context of Malaysian tax laws?

The Role of the Tax Agents

The IRB came out with a guidebook in January 2001, purportedly to explain the Role of the Tax Agent under the Self Assessment System7. Among other things, it exhorts the tax agent to adhere to integrity and competency in the proper discharge of his or her function as a tax

Cost of compliance

With increased responsibility attached to filing a return, the cost of compliance would ultimately increase for the taxpayer. The tax professional, in adhering to the requirement of competency, will take more time to comply with the tax requirements. Tax agent might even have to seek legal advice before they can advice the taxpayer8.



Diamond v Commissioners of Taxation, Administrative Appeal Tribunal (1999)

The Australian Tax Office Tax Ruling No. 94/4 at paragraph 6 ibid Para. 14(i) and 14(k)

Sec. 251M of the Income Tax Assessment Act 1936 (Australia)

Role of Tax Agents - Self Assessment System, Inland Revenue Board (January 2001)

Dr. Jeyapalan Kasipillai, "Tax Advisors' Concern over Section 114(1A) of the ITA" - article published in the STAR (Tax Matters), 6 March 2000.

With increasing complexity of taxation, the IRB should probably follow the footsteps of countries like Japan, Australia and the United States where expenses relating to tax compliance, paid to tax professionals, are deductible under the relevant tax laws.

Presently, the Malaysian IRB follows English case law in refusing to allow a deduction for tax compliance fees paid to tax professionals⁹. In the English case, a company, Farquharson Bros & Co Ltd., retained solicitors and counsel in a hearing before the Special Commissioners of their appeal against certain assessments. The legal expenses of the appeal were held to be not allowable in computing their profits, being expenses incurred after the profits have been earned.

The IRB could review the matter of deduction of tax compliance fees paid to tax professionals more liberally - in the same vein as pre-operating expenses10. Perhaps, if the said fees are allowed a deduction companies and other taxpayers could then be more focussed on earning profits whilst leaving tax compliance in the hands of tax professionals, resulting in better cost management from the job efficiencies created and a more competent economy. If accounting and auditing fees are allowed, as is presently the case, the deduction of professional fees for tax compliance as a legitimate expense will be merely an extension of this practice.

It is the author's view that if a company engages an in-house accountant to prepare the tax return, the cost is a tax deductible expense because it is the cost of employing the in-house accountant to the company. On the same footing, outsourcing such a job (preparing the tax return) to a tax professional should qualify as an expense incurred in the production of gross income. This is more justifiable in a self-assessment regime where the taxpayer, who is less well versed in tax matters, rightly seeks the assistance of a tax professional to ensure compliance with the tax laws.

The deduction of tax professional fees as a legitimate expense in determining the adjusted income of the taxpayer will help enhance the tax profession. The added benefit to the IRB is that the tax professional can shoulder some of the tax education responsibility, which the IRB takes on. For example, the IRB is setting up Business Support Units (BSU) to improve tax compliance among the small and medium scale enterprises, including small traders and hawkers11. The tax professional too can help with such training and dissemination of tax information, while enhancing tax compliance, with their ability to reach the taxpayer in a more personal and efficient manner.

It is imperative for the IRB to work closely with the tax professional, particularly in the implementation of the self-assessment system and the field audit. An atmosphere of co-operation and mutual trust and understanding must be present in any dealing between the two parties. This will ensure the smooth implementation and the ultimate success of the self-assessment system in Malaysia.

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Invitation to write

Tax Nasional welcomes original and unpublished contributions which are of interest to tax professionals, lawyers and academicians. It may cover local or international tax development.

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Contributions intended for publication must include the writer's name and address, even if a pseudonym is used. The Editor reserves the right to edit all contributions based on clarity and accuracy of expressions required.

Contributions may be sent to the Editor of Tax Nasional, Malaysian Institute of Taxation. For further information, please contact The Secretariat, Malaysian Institute of Taxation.

Allen v Farquharson Bros & Co Ltd. KB 1923, 17 TC 59 Income Tax (Deduction of Incorporation Expenses) Rules 1974 The New Straits Times, Business Times section, Wednesday, September, 2002

SECTION 75A AND SHIPWRECKS ON OUR SHORES

By Anand Raj

et's be clear about one thing - the -amendments initially introduced to sec. 75(1) of the Malaysian Income Tax Act 1967 (Act 53) ("ITA") by sec. 6 of the Finance Act 2002 (Act 619) (hereinafter referred to as "the first amendment") did not have the effect of imposing "personal liability" upon directors, company secretaries and other officers of companies and bodies of persons (hereinafter referred to collectively as "office bearers") for the non-payment of tax by such company or body of persons. The first amendment only reinforced the vicarious responsibilities2 (as distinct from vicarious chargeability3, or even "personal liability") of office bearers4.

Regrettably, the first amendment had been misconstrued as having the draconian effect of holding office bearers "personally liable" for the non-payment of taxes by a company or other body of persons, without proof of culpability or scienter on the part of such office bearers (hereinafter referred to as "the draconian view"). In my first article I had argued that this could not have been the intention of Parliament or, even if there had been a darker agenda, the language of the first amendment was inadequate and had misfired to an incurable degree. Conversely, the proponents of the draconian view appeared to take the position that the intention of Parliament was clear, and that the language of the first amendment was adequate, for the purpose of imposing personal liability upon office bearers.

If indeed the first amendment had such a draconian effect, there would be no need for the authorities⁵ to propose its repeal⁶ in favour of a new sec. 75A ITA7 (hereinafter referred to collectively as "the second amendment") less than a year later, i.e. in the very next Budget8. If the authorities felt strongly that the draconian view was the better view, that would have

been the end of the story and there would be no need for the second amendment. In light of the foregoing, there can be but one conclusion - the second amendment strikes down the draconian view in one fell swoop.

The first amendment - Section 75

The first amendment came into force on 8th February 2002 and (until the second amendment is passed) sec.75(1) reads as follows (the first amendment is shown in bold):

"(1)Notwithstanding anything to the contrary to this Act or any other written law, the responsibility for doing all acts and things required to be done by or on behalf of a company or body of persons for the purposes of this Act including the payment of tax shall lie jointly and severally -

(a) in the case of a company, with -

- i. the manager or other principal officer in Malaysia;
- ii. the directors;
- iii. the secretary; and
- iv. any person (however styled) exercising the functions of any of the persons mentioned in the foregoing sub-paragraphs; and
- (b) in the case of a body of persons, with
 - i. the manager;
 - ii. the treasurer:
 - iii. the secretary; and
 - iv. the members of its controlling authority."

To summarise the arguments contained in my first article, the draconian view of the first amendment was untenable for having violated the following critical principles of statutory interpretation:

- clear words must be used by Parliament to hold office bearers vicariously chargeable or even "personally liable" for the taxes of a company or other body this could not be achieved by a contrived process of inference and implied assertion (hereinafter referred to as the "clarity principle")
- ambiguities in taxing/penal statutes are to be construed in favour of the individual
- ut res magis valeat quam pereat every word in a statute must be given meaning and cannot be treated as dead letter - regard must be had to Parliament's retention of the less onerous concept of "responsibility" in preference to other more onerous concepts such as "liability", "vicarious chargeability" or even "joint and several liability" (hereinafter referred to as "the alternative formulations")
- statutes must be read as a whole Part IV ITA should be read in a coherent
- expressio unius est exclusio alterius -"express enactment shuts the door to further implication" - the express provisions of sec. 66 - 74 and 76 preclude any implication of vicarious chargeability under sec. 75(1)
- substantial changes in law cannot be casually inferred to arise by a sidewind
- statutes should not be read so as to result in absurdity

From a reading of Income Tax Commissioner v Chatani [1983] STC 477, a Jamaican appeal to the Judicial Committee of the Privy Council ("JCPC"), as well as other authorities, it was abundantly clear that the first amendment could not have a draconian effect as that would violate the clarity principle. In Chatani, Revenue

This is a sequel to my earlier article entitled "Of sidewinds and botched experiments: Section 75 is not a tax on office bearers which appeared as the main feature article in the 1st Quarter 2002 issue of Tax Nasional. That article was subsequently republished in the July/August 2002 issue of the Asia Pacific Tax Bulletin (International Bureau of Fiscal Documentation) and the August 2002 issue of Akauntan Nasional (Malaysian Institute of Accountants). As it would be unnecessarily repetitive to reproduce the authorities previously considered, the present article should be read in light of the earlier one. i.e. under sec. 67(4) ITA.

i.e. under sec. 67(3) ITA.

See my first article, the section entitled "The omission of the statutory formula of "assessable and chargeable" and reading Part IV ITA as a whole - what does the amended sec. 75(1) really mean?"

As it appears that the Treasury and the Revenue have acted as de facto "promoters" of both amendments, they will be referred to collectively as "the authorities"

Clause 14 of the Finance Bill (No. 2) 2002

Clause 15 of the Finance Bill (No. 2) 2002

Budget 2003, which was presented on 20th September 2002.

Jamaica purported to rely upon sec. 52 of the Jamaican Income Tax Act in attempting to hold Chatani, a director of the delinquent taxpayer company, "personally liable" for the taxes of the company. The JCPC rejected this and held that the company was chargeable to and liable for its own taxes and that the statutory provision in question (which only provided that the director was "answerable" for the company's taxes) was not sufficiently clear to hold Chatani jointly and severally liable with the company. The JCPC held further that any intention on the part of the legislature to hold a director jointly and severally liable with the company had to be expressed in clear language. Most importantly, the JCPC specifically found that "answerable" only meant "responsible" and that neither meant "personally liable". This is the clearest possible rejection of the draconian view that one can expect to find.

As every Malaysian lawyer knows, the clarity principle, which is an ancient and trite principle of common law jurisprudence, has been part of Malaysian legal philosophy at least from the 19th Century. The clarity principle has found practical application in Malaysian Revenue legislation by impelling Parliament to specifically incorporate the "joint and several liability" formulation (in regard to certain individuals) under sec. 17 of the Service Tax Act 1975 (Act 151) and sec. 26 of the Sales Tax Act 1972 (Act 64)9. (Another analogous example would be sec. 46 of the Employees Provident Fund ("EPF") Act 1991 (Act 452).) Had the first amendment been designed to impose joint and several liability or vicarious chargeability upon office bearers, Parliament could have adopted any one of the alternative formulations it had previously used for this purpose.

If the draconian view were tenable, it would mean that the clarity principle could be wantonly disregarded and that the second amendment would be unnecessary. On the contrary, it is only now with the second amendment that we find that the authorities have elected to adopt one of the alternative formulations by introducing the concept of "joint and several liability" vide the proposed sec. 75A.

Some problems with the first amendment

In my first article, the following absurdities were identified as likely to ensue by a sidewind, should the draconian view of the first amendment be upheld:

- Parliament intended even independent non-executive directors sitting on the boards of public listed companies to put their personal assets at stake
- Parliament intended to introduce an unlimited "personal liability" concept which would go much further than the existing vicarious chargeability and vicarious responsibility concepts comprehensively set out in Part IV ITA by creating a different and more onerous obligation within Part IV ITA without amending the general principle in sec. 66
- Parliament intended to impose vicarious chargeability (or even "personal liability") upon office bearers without the sec. 67 safeguards¹⁰ (or any other safeguards) applicable to "representatives" who were vicariously chargeable on behalf of various "principals" identified in Part **IVITA**
- Parliament intended to impose vicarious chargeability upon office bearers over and above the "accessible moneys" of the principal and in the absence of any culpability or scienter on the part of such office bearers

- · the concept of limited liability of companies would have to be reconfigured for income tax purposes
- the corporate veil may be lifted without any special circumstances or just reasons for so doing

As will be seen, the second amendment addresses some of the foregoing concerns. Unfortunately however, this comes at a price. We now have to face new interpretive problems, some of which are discussed below.

The second amendment

Following extensive lobbying by a broad range of interest groups, the authorities now propose that the second amendment repeal the first amendment in its entirety and replace it with a new sec. 75A, which reads as follows:

"75A. (1) Notwithstanding anything to the contrary to this Act or any other written law, where any tax is due and payable under this Act by a company, any person who is a director of that company during the period in which that tax is liable to be paid, shall be jointly and severally liable for such tax that is due and payable and shall be recoverable under section 106 from that person.

- (2) In this section, "director" means any person who -
 - (a) is occupying the position of director (by whatever name called), including any person who is concerned in the management of the company's business; and
 - (b) is, either on his own or with one or more associates within the meaning of subsection 139(7)11, the owner of, or able directly or through the medium of other companies or by any other indirect means to control, more than fifty per cent of the ordinary share capital of the company ("ordinary share capital" here having the same meaning as in the definition of "director" in section 2)." (emphasis added)

The proposed sec. 75A(1) clearly imposes "joint and several liability" upon a "director" as defined under sec. 75A(2), which is materially different from the interpretation of "director" under sec. 2 ITA (i.e. the applicable interpretation everywhere else in the ITA). For

representative in his custody and control on behalf of the

principal; or (b) being then moneys of or due to the principal,

Although some commentators have suggested that companies and office bearers might be in a "fiduciary position" under such Acts, such observations are erroneous as there are fundamental differences between statutory obligations, duties and liabilities under such Acts and the existence of a "fiduciary relationship" under Malaysian law.

e.g. payments of tax etc. are restricted to "accessible moneys" of the principal, the representative is indemnified for acting in such capacity and, for the avoidance of doubt, cannot be prosecuted for offences committed by the principal in which he had no part. For completeness, "accessible moneys" means any moneys (including any pension and any salary, wages or other remuneration) which - (a) from time to time are due from the representative to the principal or are held by the

are obtainable on demand by the representative." - see sec. 67(7) ITA

Section 139(7) of the ITA - an "associate" means, in relation to a person

a) a person in any of the following relationships to that person, that is to say, husband or wife, parent or remoter forebear, child or remoter issue, brother, sister and partner;

b) the trustee or trustees of a settlement in relation to which that person is, or any such relative of his (living or dead) as is mentioned in paragraph (a) of this definition is or was, a settlor ("settlement" and "settlor" here having the same meaning as in Section 65);

c) where that person is interested in any shares or obligations of a company which are subject to any trust or are part of the estate of a deceased person, any other person interested therein.

completeness, the interpretation of "director" in sec. 2 ITA is as follows (the underlined language is different or missing from the proposed sec. 75A(2)) –

" "director", in relation to a company, includes any person occupying the position of director (by whatever name called), any person in accordance with whose directions or instructions the directors are accustomed to act and any person who —

- (a) is a manager of the company or otherwise concerned in the management of the company's business;
- (b) is remunerated out of the funds of that business; and
- (c) is, either on his own or with one or more associates within the meaning of Section 139(7), the beneficial owner of (or able directly or through the medium of other companies or by any other indirect means to control) twenty per cent or more of the ordinary share capital of the company ("ordinary share capital" here meaning all the issued share capital of the company, by whatever name called, other than capital the holders whereof have a right to a dividend at a fixed rate but have no other right to share in the profits of the company)."

Whilst the sec. 2 interpretation of "director" is broad and non-exhaustive, the sec. 75A(2) definition is exhaustive and has a more limited scope12. The sec. 2 interpretation covers, amongst others, all directors (by whatever name called, and including persons concerned in the management of the company's business), whether or not such director owns or controls any share capital of the company concerned and whether or not that company is a private, public or public listed company. In contrast, the sec. 75A(2) definition only covers persons occupying the position of director (by whatever name called, and including persons concerned in the management of the company's business) who, either on their own or with

one or more associates, directly or indirectly own or control more than 50% of the ordinary share capital of the company (hereinafter referred to as a "controlling director"). Though the definition of "director" under the proposed sec. 75A(2) could, in theory, cover directors of public or public listed companies, in practice it is only likely to cover directors of family owned, or other tightly knit, private companies. Having said that, it is not immediately clear why the sec. 75A(2) definition of a controlling director should exclude "any person in accordance with whose directions or instructions the directors are accustomed to act".

The second amendment – some new ambiguities and problems¹³

Although the second amendment does preserve the dichotomy of vicarious chargeability and vicarious responsibility in Part IV ITA, we now have to contend with a new sec. 75A which expressly enacts the "joint and several liability" of controlling directors. Turning to the language of the second amendment, the more one deliberates upon sec. 75A the more interpretive problems one tends to notice – here are but some examples:

- a) "Notwithstanding anything to the contrary to this Act or any other written law":
 - the underlined "to" should probably be "in" and is probably a drafting or typographical error;
 - ii. regardless of the imperative nature of the language used, there are likely to be problems with this in practice. It is conceivable that some of the harsher effects of the second amendment may be mitigated by judicial decisions. (See also the discussion in sub-paragraph (c) below.)
- b) "any person who is a director during the period in which the tax is liable to be paid":
 - this could have extremely iniquitous consequences as there are no express safeguards whatsoever for a controlling director¹⁴. Under

Malaysian law, time to collect taxes (which have already been assessed) by civil proceedings does not run against the Government of Malaysia. Accordingly, the Revenue may attempt to sue a former controlling director under this sec. for unpaid taxes of the company dating back 10, 20 or even 30 years and even after the company is wound up and/or its documents lost or destroyed. Even assuming there is some mistake, e.g. the tax in question has already been paid or is not even payable, the director would have difficulty in proving it or in defending himself as the relevant documents may have been destroyed, or may be inaccessible to him e.g. if he has ceased to be a director of the company.

- c) "shall be jointly and severally liable for such tax that is due and payable and shall be recoverable under Section 106¹⁵ from that person":
 - well here's the rub. The foregoing statutory words pay lip service to the clarity principle but, regrettably, fall far short of the standards of reasonableness taxpayers should be entitled to expect of the authorities.
 - ii. A controlling director is held to be "jointly and severally liable" without any express requirement to prove culpability or scienter16 on the part of such director. In other words, the Revenue could seek to argue that even an "honest" controlling director who had fully complied with his statutory and fiduciary duties, and who had no intention to cause the company to evade the payment of its taxes, would be jointly and severally liable for the unpaid taxes of the company merely because the company did not have the money to pay e.g. due to a drop in business, negative economic conditions or some other factor beyond the controlling director's control.

¹² Contrast the use of the word "includes" in the sec. 2 interpretation with the use of the word "means" in the sec. 75A(2) definition. It should also be noted that sec. 2 is an interpretation section with the opening words "In this Act, unless the context otherwise requires — ". If it was intended that "director" should have the broader sec. 2 interpretation, sec. 75A(2) would be wholly unnecessary — per Foo Loke Ying [1985] 2 MLJ 35.

¹³ This is not, nor is it intended to be, an exhaustive list of ambiguities/problems and proposed interpretations/solutions. This section of the article only contains my preliminary observations as at the time of writing.

It may be possible to argue that certain procedural and/or substantive safeguards should be implied under Malaysian law. However, constraints of time and space do not permit a fuller discussion of such matters here.

¹⁵The material words of which are as follows — sec. 106(1) — "Tax due and payable may be recovered by the Government by civil proceedings as a debt due to the Government." and sec. 106(3) — "In any proceedings under this section the court shall not entertain any plea that the amount of tax sought to be recovered is excessive, incorrectly assessed, under appeal or incorrectly increased under Section 103 ..."

- iii. The second amendment introduces a de facto constraint upon the discharge of a controlling director's fiduciary and statutory duties to the company. Some controlling directors may become so concerned with avoiding personal liability that their judgement and impartiality in decision making are adversely affected. The interests of the company, and that of minority shareholders, are unlikely to be served in such cases.
- iv. There is no express requirement for the Government to exhaust its remedies against the company before a controlling director can be sued for the unpaid taxes. The Revenue would probably argue that it may elect to commence civil proceedings against the controlling director, the company or both17.
- What if the controlling director (e.g. wishing to avoid litigation, out of fear or for some other reason) pays first, even though the company has appealed against the assessments in question? If the company's appeal is subsequently allowed, what is the applicable refund procedure? Would the Revenue refund the taxes to the company or to the director (who may no longer be with the company)?
- vi. The second amendment may well be a roundabout way of the Revenue trying to overcome the lack of priority accorded to federal taxes under the Companies Act 1965. e.g. the sales tax case of Director of Customs Federal Territory v. Ler Cheng Chye (Liquidator of Castwell Sdn Bhd (in Liquidation)) [1995] 3 CLI 316 is instructive. In this winding up matter, the Supreme Court held that federal taxes could only be given priority in accordance with sec. 292(1) of the Companies Act 1965 (Act 125), whereunder federal taxes are ranked sixth as a

preferred debt, but only just ahead of unsecured debts generally. The Supreme Court applied the principle of generalia specialibus non derogant and held that the provisions of the Companies Act 1965, being specific legislation on priorities amongst creditors in winding up matters, would prevail over the general language of the Sales Tax Act 1972 and the Government Proceedings Act 1956. The Court of Appeal in the recent, as yet unreported, case of Carah Enterprise Sdn Bhd18 has applied this principle in the context of receivership proceedings under sec. 191 of the Companies Act 1965, in regard to a claim for income tax.

- vii. With the second amendment, the Revenue may now target controlling directors in cases where the Revenue felt the priority rules under the Companies Act 1965 could make it difficult to collect outstanding taxes directly from the company. The Revenue may even purport to suggest that they have a general discretion to target controlling directors.
- viii. While the foregoing problems will have to be resolved in time to come, I believe that the authorities are likely to meet with some disappointments along the way as Malaysian courts are likely to find ways to mitigate some of the harsher effects of the second amendment e.g. it is possible that an "honest" director who acts in full compliance with his statutory and fiduciary duties etc. may be afforded some form of procedural and/or substantive protection or relief.

Where do we go from here?

I have never been in favour of imposing any form of personal liability upon directors or office bearers. I'm still against it as it's likely to lead to unnecessary

confusion and conflict between tax law and company law. In some situations, sec. 75A may well interfere with the proper discharge of a director's duties. To make matters worse, sec. 75A does not expressly require any element of culpability or scienter19 for the imposition of joint and several liability.

Although the first amendment did not have a draconian effect, it was open to misinterpretation (and possible abuse) by persons beholden to a draconian view of it. All manner of iniquitous and absurd results would have been occasioned by a draconian interpretation of the first amendment. Fortunately, the second amendment takes us beyond such concerns20. However, while it is heartening to see that the authorities are trying to be sensitive to private sector and investor concerns, and the second amendment is an improvement (of sorts) on the first amendment, sec. 75A is still far from reasonable.

The introduction of the second amendment now requires us to focus our concerns on a smaller class of persons i.e. controlling directors (rather than office bearers of companies and other bodies of persons, irrespective of whether such office bearers have "control" or not). Nevertheless, the numerous lacunas, ambiguities, and even absurdities inherent within this limited class will still have to be adjudicated upon, on a case by case basis. This doesn't mean that I'm against further legislative refinement of sec. 75A to address its obvious weaknesses. It's just that, given all that's happened, it seems unlikely that the authorities would admit that the second amendment is flawed. Either that or the "flaws" are deliberate.

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It may be possible to argue that the requirement for some degree of culpability or scienter should be implied under Malaysian

As alluded to earlier, it may be possible for controlling directors to argue that certain procedural and/or substantive safeguards should be implied under Malaysian law. Additionally, this may be contrasted with the slightly more favourable position under sec. 26 of the Sales Tax Act 1972, sec. 17 Service Tax Act 1975 and sec. 22C of the Customs Act 1967 which specifically restrict the joint and several liabilities of directors (and other office bearers) in winding up cases. In such cases, directors and office

bearers are only liable where the assets of the company are insufficient to meet the amount due to the Government after distribution in accordance with the priorities set out under the Companies Act 1965. No similar restrictions are expressly proposed under the second amendment.

See The Star, 7^m November 2002 — "Income tax not a priority debt for receivership firms'

As alluded to above, it may still be possible to argue that the requirement for some degree of culpability or scienter should be implied under Malaysian law.

Recent shipwrecks on our shores bear witness to the running aground of ships manned by Draconians (being persons in habitual occupation of the land of Draconia) due to an inability to safely drop anchor in Malaysian waters.

The views of the author do not necessarily represent the views of the firm. Nothing herein contained should be construed as legal advice on the applicability of any provision of law to a given set of facts.

By Celina Wong Fui Li

"INTEREST FROM FD CANNOT BE TAXED" - That was the headline carried by one of our local newspapers1 when reporting the recent Court of Appeal decision in Director-General of Inland Revenue v Pan Century Edible Oils Sdn Bhd (unreported) ("Pan Century").

"Interest earned by companies from fixed deposits (FD) cannot be taxed because the Principal sum would have already been charged as the company's profit or business income, the Court of Appeal ruled yesterday."

If anyone got excited with that little piece of news, it was short-lived. The Court of Appeal did not decide that the interest earned by companies from fixed deposits cannot be taxed. Conversely, the Court of Appeal in Pan Century merely decided, in line with the case of American Leaf Blending Co. Sdn Bhd v Director-General of Inland Revenue [1979] 1 MLJ 1 ("American Leaf"), a Privy Council appeal from the Federal Court of Malaysia, that the interest earned by the taxpayer constituted business income under sec. 4(a) of the Income Tax Act, 1967 ("the Act") and not interest income under sec. 4(c) of the Act.

The Act

Section 4 of the Act sets out six classes of income upon which income tax is chargeable, and these include:

whatever period of time carried on; (b) gains or profits from an employment;

(a) gains or profits from a business, for

- (c) dividends, interest or discounts:
- (d) rents, royalties or premium;
- (e) pensions, annuities or other periodical payments not falling under any of the foregoing paragraphs;
- (f) gains or profits not falling under any of the foregoing paragraphs.

Under sec. 43 of the Act, adjusted losses from a business of a taxpayer for previous years of assessment can only be set off from a source consisting of a business under sec. 4(a) but not against income from any other sources under sec. 4 of the Act.

American Leaf

American Leaf was the landmark decision which established that there can be overlapping of the classes of income between paragraph (a) and paragraphs (c) and (d) of sec. 4 of the Act.

In American Leaf, the taxpayer was a company incorporated with the principal object of carrying on a tobacco business, i.e. to cut and blend tobacco and to manufacture cigarettes. For the purpose of running its business, the taxpayer purchased land and erected a building which included a cigarette-manufacturing factory and a bonded warehouse for storing tobacco and cigarettes. Unfortunately, the

taxpayer had to cease its tobacco business because it proved unprofitable. By this time, the taxpayer had accumulated unabsorbed business losses and unabsorbed capital allowances for income tax purposes. The taxpayer subsequently leased its factory and warehouse to various companies and derived rental income therefrom.

For the years of assessment 1968 and 1970, the taxpayer's claim to have the unabsorbed losses and unabsorbed capital allowances set off against the rental income was disallowed by the Director General of Inland Revenue ("DGIR"). The taxpayer appealed to the Special Commissioners of Income Tax ("SCIT") and the matter was brought all the way to the Privy Council.

The question for determination by the Privy Council in American Leaf was whether the rents received by the taxpayer constituted business income under section 4(a) or rental income under sec. 4(d) of the Act. Where the rents received by the taxpayer constituted business income, the unabsorbed losses accumulated by the taxpayer from the previous years of assessment would be allowed to be set off against such receipts. (The taxpayer's claim to have the unabsorbed capital allowances set off against the rental receipts was abandoned at the Privy Council appeal.)

In support of its contention that the rents received by the taxpayer constituted rental income under sec. 4(d) of the Act, the DGIR argued that as a matter of construction of the Act, income derived from the receipt of rents was incapable of constituting income from a source consisting of a business as paragraphs (a) to (e) of sec. 4 of the Act referred to five separate classes of income that were mutually exclusive.

Lord Diplock, upon examination of the Act, found however that "there is plainly room for overlapping between one paragraph and another" of sec. 4 of the Act, and this "potential overlapping between paragraph (a) and paragraphs (c) and (d) is ... put beyond doubt by the provisions of section 24 of the Act".

The Star Newspapers, 1st August 2002.

"The purpose of section 24 is to provide as an exception to the general rule that on computing chargeable income from a business, book debts arising in the period of assessment shall be brought into account although not actually received. Sub-sections (4) and (5) apply this exception to dividends and interest on securities held by investment companies and interest receivable in the course of carrying on a business of lending money; while subsection (1)(c) applies the same exception inter alia to debts arising "in respect of(c) the use or enjoyment of any property dealt with at any time in the course of carrying on a business."

So, it is clear that rents, despite the fact that they are referred to in paragraph (d) of section 4, may nevertheless constitute income from a source consisting of a business if they are receivable in the course of carrying on a business of putting the taxpayer's property to profitable use by letting it out for rent."

Further, on the question whether the taxpayer was carrying on a business of letting out its premises for rent in 1968 and 1970, Lord Diplock observed,

"In the case of a private individual, it may well be that the mere receipt of rents from property that he owns raises no presumption that he is carrying on a business. In contrast, in their Lordships' view, in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business. Where the gainful use to which a company's property is put is letting it out for rent, their Lordships do not find it easy to envisage circumstances that are likely to arise in practice which would displace the prima facie inference that in doing so it was carrying on a business."

In view of the above, the Privy Council allowed the taxpayer's appeal.

In the context of examining whether the income earned by a taxpayer was exempted from tax under the Malaysia-Singapore Double Tax Agreement, the High Court in Walter Wright (Singapore) Pte Ltd v DGIR [1990] 3 MLJ 186 applied the overlapping principle and concluded that the rents received by the taxpayer from the letting of cranes and trucks constituted business

This overlapping principle expounded in American Leaf has frequently been referred to and considered in various cases.

income under section 4(a) of the Act. Similarly, in the case of Oil (Asia) v DGIR (1997) (unreported), the High Court applied American Leaf and held that the rents received by a taxpayer from the letting of ships constituted business income under sec. 4(a) of the Act.

Pan Century, as mentioned at the beginning of this article, is a more recent case which applied this overlapping principle expounded in American Leaf. Apart from the momentary buzz caused by our local newspapers, Pan Century does provide an interesting illustration of the application of the overlapping principle to interest receipts.

Pan Century

In this case, the taxpayer was involved in the business of refining and processing palm oil. The taxpayer readily held an amount of cash from the sale proceeds of its products for the purchase of crude palm oil. However, as the price of crude palm oil fluctuated from time to time, the amount of cash needed to purchase the crude palm oil varied from time to time as well. When the price of crude palm oil dropped, the taxpayer would place the excess cash on deposits and derive interest therefrom.

The DGIR raised assessments on the taxpayer on the basis that the interest were taxable under sec. 4(c) of the Act. The taxpayer appealed to the SCIT and contended that the interest were part and parcel of its business income, or ancillary to its business or is business income arising out of an adventure or concern in the nature of trade and should be chargeable to tax as income under sec. 4(a) of the Act. The SCIT allowed the taxpayer's appeal and the case went up to the High Court, which upheld the SCIT's decision.

The issue for determination by the Court of Appeal was whether the interest earned by the company from placing its excess cash deposits was business income under sec. 4(a) and as such, business losses from the taxpayer's previous years of assessment was allowed to be set off against the interest earned.

The Court of Appeal referred extensively to American Leaf and concluded,

"In the same breath, we conclude that the interest despite the fact that it was referred to in paragraph (c) of sec. 4 of the Act nevertheless constitutes income from a source consisting of a business if it was receivable in the course of carrying on a business of putting the Respondent's excess cash to profitable use by placing it on short term and long term deposits."

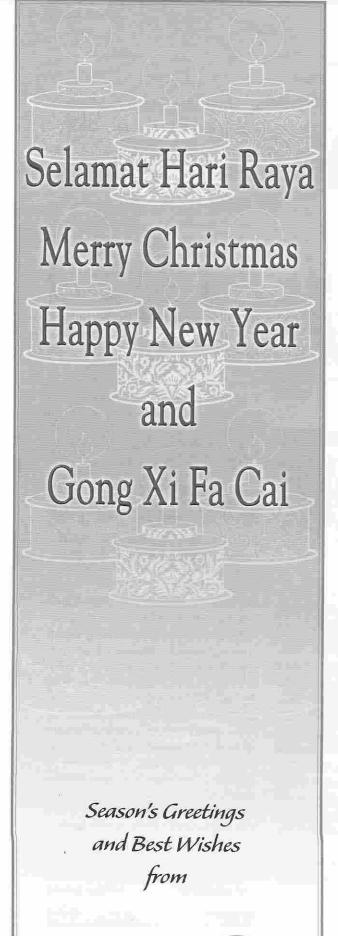
The Court of Appeal's decision was unsurprising, considering that American Leaf had already decided that there can be potential overlapping between paragraph (a) and paragraphs (c) and (d) of sec. 4 of the Act. There was however an interesting aspect of the decision.

Separate Business or Incidental to **Principal Business**

In delivering his judgment to the High Court, Hj. Abdul Kadir b. Sulaiman J observed that,

"the Commissioners disagreed with the contention of the Respondent that the placings of the deposits were ancillary to the main trade of palm oil business. They also did not accept that the two activities, i.e. processing and refining of palm oil, and the placing of the deposits are in any way closely allied. They were of the view that merely because the money earned or excess cash from the palm oil business is being placed in fixed deposits cannot, in all fairness, be said to be an activity ancillary to the processing and refining of palm oil."

The ramification of the SCIT's findings seemed to be that the interest earned by the taxpayer constituted business income from a separate business source, and was not merely incidental to the source consisting its principal business. Where income earned is considered to be derived from a separate business source from the principal business, unabsorbed capital allowances in respect of the principal business cannot be set off against the income from the separate business source.



Unabsorbed capital allowances can only be set off against the same business source. (Paragraph 75 of Schedule 3 to the Act and River Estates Sdn Bha v DGIR [1981] 1 MLJ 99)

As the taxpayer did not appeal against the above finding (from the reported High Court judgment, unabsorbed capital allowances did not appear to be an issue in Pan Century), the High Court and the Court of Appeal were not required to decide on the matter.

However, as a matter of interest, had the taxpayer pursued the argument that the placing of excess cash in fixed deposits was incidental to its principal business and not a separate business, on appeal, the taxpayer could have succeeded. It is common that in the course of running a business. there would sometimes be available excess funds which could, rather than being left idle, be placed in deposits to derive interest. In this regard, the taxpayer in Pan Century did not specifically set aside funds for placing in deposits, but was merely utilising excess funds from its principal business to derive interest from deposits.

In A Lewis and Co (Westminster) Ltd v Property Trust Ltd [1940] 1 Ch 345 ("Lewis & Co"), in determining whether a tea house was in breach of a covenant in the lease that the premises could not be used for the business of the sale of tobacco, cigar and cigarettes, Simonds J held,

"The tea-shop does not carry on the business of a tobacconist or the business of selling tobacco, cigars, or cigarettes because, as part of its business, it sells cigarettes, any more than it carries on, in ordinary parlance, the business of a retailer of milk because, in the course of its business, it sells milk, either in glasses or as an ingredient of a cup of tea."

The above observations in Lewis & Co were referred to by Faiza Tamby Chik J in Sarawak Shell Bhd & Anor v Menteri Kewangan [2001] 1 MLJ 602, in the context of determining whether a taxpayer was carrying on the business of providing management services. Faiza Tamby Chik J held,

"...the applicants merely provided incidental management services, so that similarly to what was held in the Lewis & Co's case, I therefore conclude in the circumstances that the applicants are not carrying on the business of providing management services. Management services provided under a product sharing contract to joint venture partners are incidental or in the course of the applicants' business which is the exploration and production of crude oil and natural gas."

In view of the above authorities, and notwithstanding Pan Century, a taxpayer with unabsorbed capital allowances may argue that the placing of excess cash in deposits is incidental to its principal business, and accordingly unabsorbed capital allowances (if any) relating to its principal business activity could be claimed as a set off against the interest receipts.

Given the landmark decision of American Leaf, the application of the overlapping principle to interest receipts in Pan Century, though not unexpected, is nonetheless welcomed.

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*The views of the author do not necessarily represent the views of the firm. Nothing herein contained should be construed as legal advice on the applicability of any provision of law to a given set of facts.

Shearn Delamore & Co.

DEDUCTIBILITY OF PREPAYMENT

... analyse the deductibility of certain prepayments in arriving at adjusted income for tax purposes.



By Tan Hooi Beng

Il businesses, as part of their ongoing business activity commonly make prepayments on some of their operating expenses. The main objective of this article is to analyse the deductibility of certain prepayments in arriving at adjusted income for tax purposes. The following discussions are based on the generally accepted accounting principles and the existing tax provision, namely sec. 33 of the Income Tax Act, 1967 ("ITA").

As a tax advisor, one needs to be very familiar with the general deduction provision in sec. 33(1) of the ITA. Section 33(1) read as follows:

"Subject to this Act, the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person of that person from that source for that period all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of the gross income from that source...

The following are the crucial elements in the above provision:

- outgoings and expenses;
- b. wholly and exclusively;
- e. incurred; and
- d. in the production of gross income.

The above elements are discussed in detail as follows:

a. Outgoings and expenses

It is generally acknowledged that the word "outgoings" has a wider meaning than the word "expenses". The word "expenses" would involve a cash outlay or the payment of money. However, the word "outgoings" does not only refer to disbursements and would include losses incurred in a business due to theft or defalcation by employees, the cost of free samples given out in marketing a product, specific bad debts, etc.1

b. Wholly and exclusively

The word "wholly" refers to the quantum of the expenditure, i.e. the sum of money spent in achieving a particular result. Thus, if the expenditure is remotely connected with the achievement of the purported objective, then it does not meet the "wholly" test.2

The word "exclusively" refers to the motive or object behind the incurrence of the expenditure. Thus, unless such motive or object is solely incurred in the production of income, the expenditure will fail the deductibility test. This therefore deals with the principle of duality of purpose. If the sole purpose of the expenditure is to secure a business result, then it would be allowable.2

In applying the "wholly and exclusively" concept, the motives of the taxpayer must be looked at.

c. Incurred

The word "incurred" has been defined in various cases to mean not only "paid" but also "payable" or "becoming payable". An expenditure can be incurred without being disbursed or discharged.3

As long as there is a liability to pay, an expenditure is incurred and is therefore deductible, assuming that other elements of the deduction criteria are fulfilled.

d. In the production of gross income

For an expense to be deductible, it must be proven that the outlay was for the purpose of producing income, whether in current period or future periods[‡]. An expenditure or loss made to reduce current or future expenses may also be deducted from gross income.

In order for expenses to be deductible under sec. 33(1), all of the above criteria must be met.

Allen vs Farguharson Brothers & Co 17 TC 59 (HC) Bentleys, Stokes and Lowless vs Beson (33 TC 491) (CA)

Lo & Lo vs CIR (1984) 2 HKTC 34 Port Elizabeth Electric Tramway Co Ltd vs CIR (8 SATC 13)



Prepayment expenses

From an accounting point of view, expenses to be reported in financial statements must be matched with the corresponding income. In this regard, any expenditure that is paid in a financial period, say in Year 1, but relates to the subsequent year (e.g. Year 2) must not be expensed off to the Profit & Loss Account ("P&L") for Year 1. Instead of charging the prepayment to the P& L, the same expense will be debited in the Balance Sheet ("BS") as prepayment (other debtors). However, the prepayment will be charged into the P & L in year 2.

Basically, the above accounting treatment is to conform with the conventional matching principle which was established and has been well accepted from years ago.

The above accounting transactions can be illustrated as follows:

Accounting treatment

AA Sdn Bhd paid RM15,000 in Year 1 for fire insurance where RM12,000 relates to the period 1.1.2001-31.12.2001 whilst the remaining RM3,000 relates to 1.1.2002 -31.3.2002. The prepayment of RM3,000 is required under the insurance contract (i.e. a legal liability to pay arises).

As discussed earlier, the amount of insurance expenses that would be recorded in the P&L for Year 1 would be RM12,000 (based on the accounting matching principles) whilst the RM3,000 would be booked in as other debtors in Year 1's BS.

Year 2

In Year 2, AA Sdn Bhd is required under the insurance contract to pay a premium of RM24,000 covering the period 1.4.2002 to 31.3.2003.

From an accounting perspective, out of the RM24,000 paid, the RM18,000 (for 9 months) will be charged into the P&L for Year 2 whilst the remaining of RM6,000 would be booked in BS as other debtors. On top of the insurance premium of RM24,000, the prepayment in Year 1 of RM3,000 will now be reversed out from BS to the P&L in Year 2. As such, the total of insurance premium charged to the P&L in Year 2 is RM21,000 (i.e. RM18,000 + RM3,000). The process of matching the expenses with income would continue in future years.

Tax treatment

Generally, one would emphasize P&L items in preparing a tax computation. Having said that, one must also remember that BS items are equally important in arriving at the taxable income.

Among the relevant items in the BS for tax adjustment purposes are the following:

- · Movement in fixed assets [for capital allowance purposes]
- Movement in provision for bad & doubtful debts [for purposes of sec. 34]
- Movement in provision for stock obsolescence [for purposes of sec. 35]
- Other debtors [for purposes of sec. 33(2), interest restriction
- Prepayments [for purposes of sec. 33(1)] and etc.

Year 1

Based on the above, traditionally, a modest tax treatment is to allow the amount of premium of RM12,000 charged to the P&L as a tax deduction as the said expense falls squarely within sec. 33(1). In this regard, no tax adjustment would be required in the tax computation for Year 1. Bearing in mind that in practice, a normal tax computation would begin with "profit before taxation" and not gross income.

However, reading sec. 33(1) strictly, one would note that so long as revenue expenditure is incurred wholly and exclusively in that period for the production of gross income for that source, the expenditure would rank for a tax deduction in arriving at the adjusted income. Therefore, sec. 33(1) does not adopt the matching concept under the accounting conventions, which requires revenue to be set-off against cost incurred in earning that revenue for a particular period.

Hence, for an expenditure to qualify for sec. 33(1) deduction, it need not be incurred for the production of gross income for that current period. However, as mentioned earlier, a legal liability to pay must exist at the time of making the prepayment for an expenditure to be deductible. For example, as required in some insurance contracts, insures would be required to make a payment on the insurance premium upfront. On the other hand, if a prepayment of insurance premium is made on a voluntarily basis, then the expenditure is not incurred for tax purposes since legal liability to pay does not arise at that point in time.

If the intention of the legislators is to disallow any prepayment expenses incurred in the period, then technically, sec. 33(1) should read as follows (see bold):

"Subject to this Act, the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount... in the production of the gross income from that source for that period...

In reading tax law, it is well accepted that nothing is to be implied if the intention is not spelled out clearly (Cape Brandy Syndicate v. Inland Revenue Commissioners [1921] 1 KB 64, 2 KB 403).

Against the above argument, it is submitted that prepayment for insurance premiums (in this case) will be accorded a tax deduction in Year 1 itself although the said prepayment is not expensed off to P&L for accounting purposes. The reason is simply because of all the criteria under sec. 33(1) have been met. Hence, the appropriate tax adjustment in the tax computation for Year 1 is to claim a deduction of RM3,000 (i.e. less out RM3,000 from profit before tax).

Tax computation – Year 1

	RM
Profit before tax	100,000
Add/(Less): Depreciation	1,000
Prepayment	
(balance sheet item)	(3,000)
Adjusted income	98,000



Year 2 So, what is next in Year 2?

In Year 2, as mentioned earlier, the amount of insurance premiums to be booked in the P& L would be RM21,000 (i.e. prepayment of RM3,000 from Year 1 + premium for 9 months in Year 2 of RM18,000)

For tax purposes, similarly, one should disallow the prepayment of Year 1 of RM3,000 (as it was incurred in Year 1 and not in Year 2 and also a deduction was already claimed in Year 1) whilst the prepayment in Year 2 of RM6,000 would be claimed.

Tax computation - Year 2

	RM
Profit before tax	110,000
Add/(Less):	
Depreciation	1,000
Prepayment in year 1	3,000
Prepayment in year 2	
(balance sheet item)	(6,000)
Adjusted income	108,000

Practical perspective and avenue for tax planning

One may argue that the claiming of prepayment in Year 1 and disallowing it Year 2 (and this process continues in subsequent years) does not benefit the mxpayer as the deduction would be accorded anyway in the following years Le. a timing difference).

the taxpayer may not want to incur additional cost or time in analysing prepayment

Also, a taxpayer may not wish to adopt this approach as this may cause unnecessary dispute with the Revenue, especially in view of the self-assessment system in Malaysia. In addition, the taxpayer may not want to incur additional cost or time in analysing prepayment and keeping a movement of the same in order to ensure the correct amount to be claimed and disallowed in the annual tax computation.

Having said that, the author is of a view that the above practical difficulties can be overcome if a taxpayer has a good accounting system which is updated regularly. In addition, so long as a taxpayer can substantiate a claim on prepayments where a legal liability exists (for e.g. by having documentary evidence readily kept in file such as insurance contract, policy and receipts), no dispute should arise with the Revenue. After all, there is nothing wrong with claiming a prepayment as this approach is in accordance with sec. 33(1) of the ITA.

The author would also wish to point out that an upfront claim of prepayment in Year 1 will benefit the taxpayer in terms of cash flow especially if the quantum of prepayment is substantial. Also, a taxpayer adopting this approach will benefit if there is a decrease of tax rate in year 2 as compared to Year 1.

Other prepayments that do not rank for Section 33(1) deduction

It is important to note that sec. 33(1) is a general deduction provision that accords a deduction for any expenses incurred in the basis period for the production of gross income from a source. To reiterate, any expenses, including prepayments (where a legal liability to pay arises) that fall squarely within sec. 33 will be accorded a tax deduction in arriving at the adjusted income (bearing in mind of the prohibition under sec. 39).

However, the claim for prepayment for tax purposes does not apply to rental of immovable properties (i.e. land and building) as sec. 33(1)(b) [which is a specific provision as opposed to the general provision provided in sec. 33 (1)] reads as follow:

"rent payable in respect of any land or building occupied during that period for the purposes of producing gross income"

Based on the above, it is clear that advance rental, prepayment for rental and deposit in relation to the rental for land and building are not deductible for tax purposes. However, the rental of moveable properties (for e.g. plant and machineries, cars, etc) are not within the ambit of sec. 33(1)(b). Hence, one would have to rely on the general provision of sec. 33. In other words, a deduction for prepayment of moveable properties should be accorded based on the reasoning explained earlier.

Although it is generally the view that prepayment be claimed on an accruals basis, the above discussion argues in favour of claiming a deduction for these expenses when they are incurred. on the basis that it is in line with the sec. 33(1) definition.

The Author

The author is a tax consultant specialising in corporate tax.

Note: The views expressed in the article are the personal views of the author.



Refund of Sales Tax/By Bong Sesh Chin Service Tax on Bad Debts

he Prime Minister, in his capacity as Minister of Finance, unveiled the 2003 Budget on 20 September 2002. While it was perceived that the corporate tax rate would be reduced to attract FDI, the government has unexpectedly adopted different strategies by focusing on strengthening the country's resilience from within.

Increasing domestic investment in all sectors with growth potential is one of the strategies adopted. In line with this strategy, various measures were proposed to reduce the cost of doing business in order to enhance competitiveness. These measures, among others, include the refund of sales tax and service tax in respect of bad debts.

When taxes become due and payable

The existing legislations prescribe the time frame for the payment of sales tax and service tax, irrespective of whether amounts on which such tax are chargeable have been recovered from the debtors. In the case of service tax, tax becomes payable when payment is received for the taxable services rendered, or in the event that payment is not received within 12 calendar months from the date of issuance of the invoice, the day immediately after the expiry of the 12 calendar months. This is provided under sec. 14 of the Service Tax Act 1975 which reads:

- "14. When tax becomes due and payable
 - The service tax chargeable under this Act shall be due at the time when payment is received for the

taxable services provided to the customer by the taxable person.

- Where the whole or any part of the payment for any taxable service provided by the taxable person is not received from the customer within a period of twelve calendar months from the date of the invoice for the taxable service provided, service tax shall be due on the day following that period of twelve calendar months.
- 3. Any service tax which falls due under subsection (1) or (2) during any taxable period shall be payable to the Director General within twenty-eight days from the expiration of that taxable period.
- 4. Notwithstanding subsection (1), (2) or (3), service tax required to be accounted in any return made under subsection 12(1A) shall be due and payable on the day the return is required to be delivered to the proper officer."

Service tax due under sec. 14(1) and 14(2) is to be paid to the Director General of Customs within 28 days from the expiration of the taxable period.

It is noted that licensed manufacturers are not accorded the same treatment as the service providers in respect to payment of tax. Unlike service tax, where the tax is due upon receipt of payment or after expiration of a 12-month period, sales tax is due at the time the taxable goods are sold or disposed of, otherwise than by sale by the licensed manufacturers. Sales tax which falls due in any taxable period shall be payable to the Director General of Customs within 28 days.

It should be noted that consideration for the sale of taxable goods or provision of taxable services which has been written off as bad debt is not exempted from tax. Neither is there provision under both the Service Tax Act 1975 and the Sales Tax Act 1972 that allows irrecoverable tax to be treated as bad debts. Licensed manufacturers or service providers are not entitled to a refund of tax in cases of bad debt or insolvency where the licensed manufacturer or the service provider is unable to recover the proceeds of sales.

Proposed legislation

It is proposed that licensed manufacturers or service providers be eligible to apply for a refund of tax, which has been paid to the Director General of Customs when such tax remains irrecoverable and has been regarded as a bad debt. The proposed legislation takes effect from 1 January 2003.

It is envisaged, as in the case of a refund of tax overpaid or erroneously paid, the power to refund tax in respect of bad debts would be bestowed on the Director General of Customs. In this respect, the 1-year limitation applicable to the Director General of Customs to grant the refund of tax overpaid or erroneously paid will not apply



to bad debts. In addition, the proposed legislation will prescribe the manner in which the claim for a refund is to be made and conditions under which such a claim may be approved.

Circumstances under which tax is deemed a bad debt

In common with other claims for a refund of tax, it is the duty of the applicant to prove, that the sales tax or service tax paid is unlikely to be recovered and is to be written off as a bad debt. In this connection, unrecovered sales tax or service tax can be considered a bad debt in the following circumstances:

- the licensed manufacturer or service provider is unable to collect the debt from the customer after the expiry of 12 months from the date of payment of tax;
- the debtor had been adjudged a bankrupt under the Bankruptcy Act, 1967:
- the debtor had been placed under receivership or official assignee;
- the debtor had been ordered by the court to wind up;
- the licensed manufacturer or service provider has filed a claim in court to recover the tax or has initiated action for the customer to be adjudged a bankrupt.

Contra method

While the Malaysian tax authority decides to adopt the refund mechanism in respect of irrecoverable sales tax or service tax, certain countries (e.g. New Zealand) have chosen to apply the contra method, to allow tax licensees offset the bad debts from their next payment of tax.

The contra method is easier to operate and considerably reduces the workload of the tax authorities.

Service tax which becomes bad debt prior to its payment

Service tax legislation allows a service provider a period of 12 months to make payment for service tax that has not been recovered from the customer. Commercially. it is not uncommon that service tax becomes a bad debt before the expiry of the 12-month period. In the absence of provisions to exempt such service tax which has become a bad debt, it appears that the service provider, in order to circumvent being penalised, needs to pay such service tax and apply for the refund later. In all cases, it is absurd for one to make a payment of service tax when he knows fully well that such service tax is to be subsequently refunded. Under such circumstances, the service provider may apply to the Minister for an exemption from paying service tax which has or will becomes a bad debt before the tax is due. The power to exempt is provided under subsec. 6(a) of the Service Tax Act, 1975 which reads:

"Section 6 Powers of Minister to exempt and refund

The Minister may, in any particular case, subject to such conditions as he may deem fit to impose-

- exempt any person or class of persons from the payment of the whole or any part of the service tax which otherwise would have been payable by that person or that class of person;
- b) exempt any....."

Alternatively, the Minister may consider an application for a remission of service tax due and payable when it can be established to his satisfaction that such service tax has indeed become a bad debt. It is hoped that the Minister would exercise judiciously the power to remit as conferred to him by sec. 22 of the Service Tax Act 1975:

"Section 22 Remission

The Minister may, if he thinks it just and equitable to do so, and subject to such conditions as he may deem fit to impose, remit the whole or any part of any service tax or other moneys due and payable under this Act, or the whole or any part of any penalty payable under the provisions of section 16."

A similar provision under sec. 33 of the Sales Tax Act 1972 applies in respect of sales tax that is written off as a bad debt when it becomes due and payable.

Recoveries

The authorities are expected to come out with guidelines on bad debts, including the treatment of bad debts which are recovered after the refund claim has been approved. In all such cases, should any of the bad debts be entirely or partially recovered at a later date, the tax portion of it must be accounted for to the Director General of Customs.

The objective of allowing a refund of sales tax or service tax in respect of bad debts is to reduce the tax burden unjustly imposed upon licensed manufacturers or service providers.

The adoption of this measure acknowledges the Government's recognition of the role of licensed manufacturers and service providers, to be acting merely as the government's agent in collecting such taxes. As such, it is believed that the use of the contra mechanism would be highly justifiable and appropriate since it is administratively. a more efficient mechanism in avoiding delays. In striving towards a culture of corporate governance, as is often stressed by the Prime Minister, a little more trust and responsibility wouldn't be too much to place upon these agents, for want of an efficient recovery system. After all, we are now a "self-assessment" society as far as the Inland Revenue Board is concerned.

On a final note, it is contemplated that the refund mechanism will impose a higher workload on the part of the tax authorities. As such, the tax authorities should take efficient measures to prevent delays in approving the volume of refunds, as is foreseen.

The Author

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Taxation of e-Commerce

An Indian Perspective

By Hitesh Sharma & Vikram Dosh

he fact that e-Commerce has revolutionised traditional business models and methodologies has led to a lot of action at various tax forums around the world. This is because both, domestic and international taxation, may not be able to cope up with myriad forms of evolving business concepts that are thrown up in e-Commerce.

Tax systems around the world rely on traditional concepts such as physical presence of business, physical trade execution, etc for levying and collecting taxes. They are not geared for concepts such as virtual presences, virtual trade execution and virtual business conduct.

Governments have realized that there could be large-scale tax base erosion due to such revolutionary business concepts. Also, industry forums anticipate that in their over zealousness to protect the tax base, Governments may impose unnecessary tax laws in relation to e-Commerce transactions.

Accordingly, Government bodies and industry forums have been working overtime to ensure that fair and equitable tax systems are evolved in dealing with e-Commerce transactions.

India is no exception to the general rule. Whereas, on one hand it is going all out to promote investments in the Information Technology sector, on the other hand, it is echoing the concerns that any Government would have - possible tax base erosion.

In this article, the authors briefly discuss the tax structure in India relevant to cross border e-Commerce transactions, the recent overseas developments in this regard and their impact on the tax policy in India. Domestic e-Commerce issues have not been discussed since domestic e-Commerce transactions hardly raise any issues except the need for stricter enforcement.

This article does not purport to cover and address all possible types of e-Commerce transactions and issues, since such a short article would be unable to do so. However, wherever possible, key transaction types have been discussed along with relevant ramifications.

Taxation in India

The two basic internationally accepted principles of taxation, which are also embodied in the Indian IncomeTax Act, 1961 ("IT Act"), are:

- Taxation based on residence; and
- Taxation based on source.

In the Indian context, residence based taxation involves taxation in India of an Indian resident on its worldwide income. A company is deemed to be resident in India, if:

- It is an Indian company; or
- During a tax year, the control and management of the company is wholly situated in India.

Conversely, non-corporate taxpayers (partnership entities, association of persons, etc) would be treated as resident in India, even if a part of their control and management were situated in India during the tax year.

The principles of source based taxation in India are pretty wide and seek to inter alia cover the following types of transactions:

- · Income arising from a business connection in India
- Income arising from any property, asset or source of income situated in India
- Royalty or technical service fee ('TSF') paid by an Indian entity to a non

As discussed in the subsequent paragraphs, royalties and TSF are widely defined and cover more aspects than those generally covered in double tax avoidance agreements ('tax treaties').

Since countries levy tax on both residence and source, there is double taxation of income. To mitigate such double taxation. tax treaties are executed between countries.

The IT Act permits a person (definition of person includes companies also) liable to be doubly taxed on his income to choose between the provisions of the IT Act and the applicable tax treaty, as may be more beneficial to him.

Residence based on place of effective management

As discussed earlier, residence under the IT Act depends on the place of control and management. This concept depends inter alia on the place where key management and commercial decisions necessary for conduct of the business are taken.

The concept of "effective place of management" applied under tax treaties as a tiebreaker rule in case of dual residencies of companies depends on similar factors.

In the traditional context, the above concept relies on factors such as place where directors/other top-level personnel exercise their power and authority, place where busîness transactions take place, etc.

With technological aids such as video conferencing etc, the concept of effective place of management gets blurred and confusing. Further, taxpayers can easily use such technological tools to shift their place of management.

In the Indian context, Indian multinational companies can ensure that their overseas subsidiaries are not taxable in India in respect of their worldwide income based on residence, by placing directors/key personnel of such subsidiaries in the respective countries where the subsidiaries are located. Using technological aids, the Indian multinational can still control operations of the overseas subsidiaries from India.

From boom to bust...in its recent lifecycle, e-Commerce has generated a lot of commercial hype and interest. It has also aroused the interest of the taxman!

Thus, if the concept of place of effective management is not altered the real challenge for revenue authorities would be to examine each situation based on facts and circumstances of each case. This obviously would entail the revenue authorities approaching each case with a level of subjectivity.

Besides residence based taxation, advancement in technology and growth in e-Commerce also affects source based taxation. Under tax treaties executed by India, source based taxation inter alia depends on either taxation of business profits of a Permanent Establishment ('PE') of a foreign company in India or taxation of royalty/TSF.

As discussed in the following paragraphs, such source based taxation of profits of a PE or as royalty/TSF poses its own set of challenges.

Tax on profits of a foreign company's PE in India

Under tax treaties executed by India, business profits of a foreign company would be taxable in India only if the foreign company has a PE in India.

Traditionally, the concept of PE under tax treaties focuses on having a fixed place of business. Further, activities carried out through that fixed place of business should be core activities - they should not be auxiliary or preparatory activities.

Growth of e-Commerce poses a significant challenge to the above traditional concept of PE as envisaged under tax treaties. Significant business operations may be carried out in India but still there may be no PE in India. For example, in a simplistic situation, a foreign company may enter into subscription contracts with customers in India to provide them information/data directly through secured net based access from outside India. There is no need for the foreign company to have any fixed place of business in India. Accordingly, there would be no

PE of the foreign company in India. Where the payments do not classify as royalty/FTS, the income of the foreign company would not be taxable in India at all.

Similarly, where a server of a foreign company is located in India and it is used by the foreign company in its income earning activity in India, as per the OECD guidelines, the server may not classify as a PE if the server does not perform the core business of the foreign company in India. In situations where the server is used just for order booking or routing, and the delivery and procurement system is still physical, based on the above principles the server in India may not classify as a PE.

The above issues arise in the interpretation and application of a typical tax treaty executed by India. Interestingly, such issues do not arise under the IT Act which has concepts of source based taxation such as business connection, asset, property or source of income situated in India which may be wide enough to cover the above type of situations.

Further, the whole concept of PE in the backdrop of e-Commerce transactions is still emerging and various countries are adopting independent positions in this regard, for e.g. some countries have held that stand alone automated equipments could be regarded as a PE. Similarly, the revenue authorities in India may also be inclined to look at the PE concept creatively in line with the position in the IT Act, as discussed above.

Considering such issues as discussed above, at various forums, there have been discussions to devise an alternate concept

In this connection, in its report to the Central Board of Direct Taxes (i.e. the apex tax authority in India), the High Powered Committee on Electronic Commerce and Taxation1 has suggested exploring alternatives such as 'Base erosion

approach' as suggested by Professor Richard L Doernberg of University School of Law, Atlanta, in his paper presented to International Fiscal Association ('IFA') in November 2000. This concept requires that a low withholding tax be levied on all remittances outside the source country, claimed as tax deductible by enterprises in the source country.

However, this concept would have issues it may increase the cost of doing business and also increase the need to have greater administration. Thus, any such new concept would need further refinement and adjustment.

Royalties/TSF taxation

As stated earlier, royalties/TSF have been widely defined under the IT Act. The term royalty inter alia encompasses payments for:

- Usage or transfer of rights including licensing, of a patent, invention, model, design, secret formula or process or trade mark or similar property
- Transfer of rights including licensing, of any copyright, literary, artistic or scientific work
- The use or right to use any industrial, commercial or scientific equipment

From an e-Commerce payment perspective, the definition of royalty under the IT Act is very wide and encompasses almost all payments involving intellectual property of any kind in any manner.

Similarly, many tax treaties executed by India including those with the UK and the US include definition of royalty on similar lines.

For appropriate taxation, an income needs to be appropriately characterized. In characterization of income, the main conflict that arises is whether the payment is business income (to be taxed only if the foreign company has a PE in India) or royalty/TSF income.

Adopting a very simplistic technical approach in respect of the definition of royalty in the IT Act and the tax treaties, payments for commercial exploitation of any copyrighted product or intellectual property would be classified as royalty.

Rapid proliferation of technology and growth in e-Commerce has thrown up so many permutations and combinations involving usage of intellectual property that applying simplistic technical interpretations could do injustice at times.

For instance, would sale of limited duration shrink-wrap software (by way of grant of a user license) be a sale of a product or would it involve consideration for use of an intellectual property? Also, how would access fee for using software on a server for remote processing be classified? Is it a service being rendered? Is it payment for use of equipment? Further, would sale of a book online be any different from sale of a book in a bookshop?

From an Indian perspective, the revenue authorities have given a wide interpretation to the above definition of royalty and given the vagueness surrounding e-Commerce transactions, the inclination seems to be in favour of taxing payments for processing charges, software and use of equipment as royalties. For example the Advance Ruling Authority ("AAR")2 in the case of a large American Corporation has ruled that payment for use of a US company's central processing unit ("CPU") situated in the USA as well as its consolidated data network ("CDN") would be taxable as royalty. In this case, the CPU had its own software and was operated by the US company's personnel.

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Keeping such issues in mind, the OECD has revised its commentary on Article 12 dealing with software payments. The key principle being advocated by OECD is that the rights granted under each case should be examined and then classification of income should be undertaken. The revised commentary distinguishes between copyright in a software program and software incorporating a copy of the copyrighted article. Further, the Technical Advisory Group ('TAG') of the OECD has classified various e-Commerce transactions into 28 categories for income characterisation purposes.

In its report to the CBDT, the High Powered Committee in the backdrop of the India-US and India-UK treaty, has not agreed with the classification suggested by the TAG in respect of 13 (out of 28) categories. Primarily these categories pertain to electronic ordering and downloading of digital products, limited duration or single use software or digital products, application and website hosting,

application service provision, data warehousing, customer support over computer network and subscription to a website allowing downloading of digital products. Whereas the OECD has suggested that payments for these types of payments would classify as Business Profits, the High Powered Committee has suggested that such payments should be taxed as royalties/TSF.

In this context, it must be mentioned that though India is not a member country of the OECD, nonetheless the Indian government is becoming increasingly aware of global thoughts on taxation in the e-Commerce field and their impact on tax revenues. In this connection, the Indian government had sought public comments/ suggestions on the report of the High Powered Committee. Presently, the government is considering the report and comments on the report before finalising the draft legislation on taxation of e-Commerce.

Given the issues surrounding PE based taxation of Business Profits in India, there is a shift in favour of source-based taxation such as royalty/TSF. Also, discussions are focusing on altering the concept of PE to keep up with the dynamics of e-Commerce.

Every country intends to protect the integrity of its tax base - India is no different. Therefore, while on one hand a country would look up to and monitor international developments on tricky issues such as e-Commerce taxation, the backdrop would be protecting the integrity of its tax base. In such a situation, it is going to be a difficult task to achieve international consensus.

e-Commerce is going to affect the existing balance between source and residence based taxation. It is quite possible that gradually there will be a lesser need to have any kind of physical presence in an importing country to conduct business. Characterisation of income would in such a situation obviously assume importance. Liberal interpretation of source based taxation rules would in such a situation raise concerns for importing countries since their tax base could shrink.

Thus, there may be a need for looking at taxation tools beyond source and residence based taxation. These should nonetheless embody the fundamental principles of fair taxation such as neutrality, certainty, simplicity, effectiveness and flexibility.

Further, equitable sharing of revenues could be a crucial factor in achieving international consensus, without which, there is a risk of unilateral taxation by countries, which will ultimately harm the growth of international trade and business.

The High Powered Committee on Electronic Commerce and Taxation was constituted by the Central Board of Direct Taxes ('CBDT') to inter alia examine issues related to eCommerce and to suggest changes required in the domestic law / tax treaty law in light of recent developments in the field of eCommerce. The committee members constituted industry representatives, revenue authorities and professional advisors. The committee submitted its report in July 2001. The CBDT has made the report public in September 2001 and has invited public comments in respect of the report.

At the option of a non-resident, the IT Act provides for advance determination of tax treatment of transactions to be undertaken by the non-resident. The AAR is an authority specially constituted for this purpose. The decision of the AAR is binding for that transaction on both the non-resident and the revenue authorities. However, such rulings are not binding on other cases, even if similar.



Restructuring arrangements in line with Government policy is not tax avoidance

The 1st taxpayer owned over 90% of the equity of the 2nd taxpayer company. A Reconstruction Agreement was entered into whereby the 2nd taxpayer agreed to purchase a piece of land from the 1st taxpayer.

The common solicitors for the taxpayers requested of the Collector for relief from stamp duty under the *Stamp Duties Act* 1949 ("the Act"). The Collector replied requesting for confirmation from the Foreign Investment Committee ("the FIC") that approval for the land transfer was not needed. Whereupon the solicitors' application the FIC replied that there was no objection to the transaction provided that the 2nd taxpayer would have 30% equity for a Bumiputera Company by December 1997. The taxpayers then terminated the Reconstruction Agreement and entered into a fresh one. They then once again sought stamp duty exemption on the fresh transfer instrument and enclosed, *inter alia*, a copy of the FIC's consent to the transaction.

The Collector, however, rejected the application on the basis that the 2nd taxpayer did not divest 30% of its equity to a Bumiputera Company by a certain date. Also, since the arrangement was such that the 1st taxpayer would cease to have more than the requisite 90% of the equity in the 2nd taxpayer within the meaning of the Act, the instrument of transfer did not qualify for exemption from stamp duty.

The case went up to the Court of Appeal on the issue of whether the fresh instrument of transfer was executed in "pursuance of or in connection with an arrangement", whereunder the 1st taxpayer ceased to be associated with the 2nd taxpayer within the meaning of the Act.

The Court allowed the appeal on the grounds that no arrangement was made between the associated companies to avoid paying stamp duty on either the 1st or 2nd transfer instrument.

In the context of the Act it cannot be said that an imposition of a condition by the FIC, which the taxpayers felt compelled to abide, meant that there was the intention to avoid paying stamp duty on the transfer instrument.

The issue of exemption from stamp duty on the transfer instrument between the taxpayers was separate from the issue of the imposition of the condition by the FIC, which was a policy matter where the remedy for non-compliance of the FIC condition lay elsewhere, not under the Act. Therefore as the Act did not apply, the fresh transfer instrument was exempt from stamp duty.

General Produce Agency Sdn Bhd & Anor v. Pemungut Duti Setem Court of Appeal, Malaysia (Kuala Lumpur). Civil Appeal No. P-02-833-98 Judgment delivered on 19 June 2002.

Rumi Manecksha (of M/s Ong & Manecksha) for the taxpayer. Khairuddin Abdullah (Legal Officer Inland Revenue Board) for the Collector of Stamp Duty.

"Editorial Note: These cases will be reported in the forthcoming issue of Malaysian & Singapore Tax Cases."

Interest income can be business income

THE TAXPAYER WAS IN THE BUSINESS OF REFINING AND PROCESSING PALM OIL. THE PRICE OF CRUDE OIL (RAW MATERIAL) AND HENCE THE AMOUNT OF CASH NEEDED TO PURCHASE THE CRUDE PALM OIL, FLUCTUATED FROM TIME TO TIME. A CERTAIN AMOUNT OF THE CASH WAS TO BE READILY HELD FOR THE PURCHASE OF THE CRUDE PALM OIL. WHEN THE PRICE OF PALM OIL DROPPED AND LESS CASH WAS NEEDED TO FUND THE PURCHASE, THE EXCESS CASH WAS PLACED ON EITHER SHORT OR LONG TERM DEPOSITS TO GENERATE INCOME. THIS PLACING AND LIFTING OF DEPOSITS CONTINUED ON A REGULAR AND REPETITIVE BASIS FOR THE RELEVANT YEARS OF ASSESSMENT AND STILL CONTINUED UP TO THE TIME WHEN THE SPECIAL COMMISSIONERS OF INCOME TAX ("COMMISSIONERS") HEARD THE APPEAL. THE TAXPAYER EXERCISED MANAGERIAL AND ORGANISATIONAL SKILLS IN THE PLACEMENT OF ALL THEIR DEPOSITS WITH THE BANKS BY MONITORING DAILY, THE PALM OIL PRICE FLUCTUATIONS, ANALYSING THE REUTER AND NEWSPAPER REPORTS, AND THEIR BANKERS' ADVICE.

The Director-General raised an assessment against the taxpayer in respect of the interest income under sec. 4(c) of the *Income Tax Act 1967* ("the Act"), on the basis that the interest income was so chargeable.

The taxpayer appealed against the assessment to the Commissioners who ruled in their favour. The present action was therefore an appeal by the Director-General against the decision of the Commissioners which was confirmed in the High Court. The issue was whether the interest income of the taxpayer derived from placing its excess cash in short and long term deposits was business income under sec. 4(a) or interest income under sec. 4(c) of the Act.

The court held that interest, despite the fact that it was referred to in sec. 4(c) of the Act, nevertheless constituted income from a source consisting of a business if it was receivable in the course of carrying on a business of putting the taxpayer's excess cash to profitable use by placing it on short term and long term deposits. The Commissioners were therefore correct in their decision in holding that the interest income fell within sec. 4(a) of the Act.

Ketua Pengarah Hasil Dalam Negeri v. Pan Century Edible Oils Sdn Bhd Court of Appeal, Malaysia. Civil Appeal No. W-01-200 of 1997 Judgment delivered on 31 July 2002.

Hazlina Hussain & Ahmad Isyak Hassan (Legal Officers Inland Revenue Board) for the Appellant.

Dr Arjunan Subramaniam (of Geraldine Yeoh Arjunan & Associates) for the Respondent.

A Student's Guide to Tax

Employment Income (cont'd)

In the last article, we looked at the taxable benefits received by employees that are in the form of monies or convertible to cash and settlement of the employee's pecuniary liabilities by the employer in sec. 13(1)(b) and (c). In this article, we shall look into the taxability of other benefits and payments received by the employee in accordance with the provisions in sec. 13(1)(d) and (e) and relevant precedents established in tax cases.



SECTION 13(1)(d) reads:

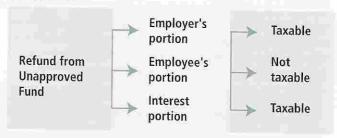
so much of any amount (other than pension, annuity or periodical payment falling under section 4(e) received by the employee, whether before or after his employment ceases, from a pension or provident fund, scheme or society not approved for the purpose of this Act as would not have been so received if his employer had not made contributions in respect of the employee to the fund, scheme or society or its trustees

This sub-section deals with refund from unapproved fund/ scheme/society. An approved fund includes EPF & any pension or provident fund, scheme or society approved by the Director-General under sec. 150 of the Income Tax Act 1967. To receive an approval the fund/scheme/society is required to invest a certain percentage of its funds in specified investments. Sometimes, employers may feel that they need a free hand to decide where to invest their funds and therefore, refrain from seeking approval.

The consequence of this is that when the employee retires and receives a refund of all contributions in his account, the employer's portion of refund will be subject to tax. However, the employee's portion is not taxable because in each of the years that he has worked, the gross income (NOT net after contribution to pension fund) is taxed under sec. 13(1)(a). The interest received would also be taxed.

In the case of LYS v DGIR (1974) 1 MLJ 96, where a pension or provident fund was previously approved but the approval was subsequently revoked, all contributions made by the employer, if they are received by the employee after the fund loses its approved status, are to be included as part of the gross income from that employment. Therefore, you evaluate the status of the fund at the point of receipt of the refund.

SUMMARY



SECTION 13(1)(e) reads:

any amount received by the employee, whether before or after his employment ceases, by way of compensation for loss of employment, including any amount in respect of:

- a covenant entered into by the employee restricting his right after leaving the employment to engage in employment of a similar kind;
- ii) any agreement or arrangement having the like effect

This sub-section deals with the taxability of compensation for loss of employment and payments in respect of restrictive covenants. Payments of this nature include salary or wages in lieu of notice (that should have been given by the employer), compensation for breach of a contract of service by the employer, payment to obtain release from a contingent liability under a contract of service and ex-gratia or contractual payments such as redundancy, retrenchment payments, severance pay etc.

However, an exemption is available under Para. 15 of Sch. 6 of the Income Tax Act 1967 as follows:

- For non-service directors of controlled companies
- If due to ill-health
- All other cases

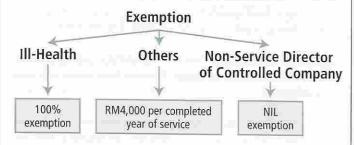
No exemption Full exemption

RM4,000 per completed year of service with the same employer

- Paragraph 15(2) states that "same employer" includes different employers
 - where control and management of different businesses remain with the same person
 - whose businesses are conducted by or through a central agency

This is summarised below:

EXEMPTION FOR COMPENSATION FOR LOSS OF EMPLOYMENT / RESTRICTIVE COVENANTS – PARAGRAPH 15 SCHEDULE 6



MIT TAX I DEC 2001 Q2 (abstract)

Mr Leong opted for a Voluntary Separation Scheme (VSS) on 31st December 2000 and was paid 10¹/₂ months of his last drawn salary (RM20,000 per month). Calculate the gross income to be included under sec. 13(1)(e).

	RM
Compensation for loss of employment	
Amount received under VSS	
(10 ¹ / ₂ months x RM20,000)	210,000
Less: Tax exemption (RM4,000 x 10 years)	40,000
	170,000

MIT TAX IV DEC 2001 Q5

Ted E. Bear is an extremely talented and experienced Dangdut singer and dancer. XYZ Executive Dangdut Sdn Bhd ("XYZ") approached him on 1st October 2001 with an offer of employment. Ted E. Bear was offered the post of Head of XYZ's Dangdut Operations Department, with effect from 1st January 2002. In order to make way for Ted E. Bear, Daff E. Duck, a veteran Dangdut dancer, is to be made redundant by XYZ with effect from 31st December 2001 and is offered the following severance package:

- a) i) RM150,000 compensation in recognition of his 40 years in service, to be paid on 15th December 2001; and
 - ii) a further payment of RM135,000 to be paid on 15th December 2001 in consideration of Daff E. Duck agreeing never to dance for, teach at, or be in any way associated with any other Executive Dangdut Club anywhere in Malaysia ever again.

Advise Daff E. Duck on the chargeability to income tax of both such payments.

Solution

Note that the (a)(i) constitutes a compensation for loss of employment whereas (a)(ii) is a restrictive covenant and are taxable under sec. 13(1)(e) of the *Income Tax Act 1967*. However, Daff E. Duck can enjoy an exemption under Para. 15 of Sch. 6, since he is not a non-service director of a controlled company, but since he is not being made redundant due to ill-health, the exemption is restricted to RM4,000 per completed year of service.

	RM
Therefore,	
Section 13(1)(e) income	285,000
Less: Para, 15 exemption RM4,000 X 40 years	(160,000)
	125,000

In the recent Malaysian case of HSG v KPHDN (2000) MSTC 3,170, a bank officer who accepted a lower position because he was afflicted with polymyositis, subsequently opted for a voluntary separation scheme and received compensation for loss of employment. He claimed a full exemption on grounds of ill-health. The High Court confirmed the Special Commissioners finding that the taxpayer's loss of employment was a choice made by the taxpayer when he participated in the scheme and not because of health reasons. [Refer to Case Digest in Tax Nasional 1st Quarter / 2002]

COMPENSATION RECEIVED FOR LOSS OF EMPLOYMENT SHOULD BE DIFFERENTIATED FROM GRATUITY

Though both represent lump sum payments just before cessation of employment but are they significantly different from a tax viewpoint as charted below:

COMPENSATION FOR LOSS OF EMPLOYMENT
Taxable under sec. 13(1)(e)
Exemption available under Para. 15, of Sch. 6
Not stipulated in the employment agreement
It is paid for cessation of employment
There is still prospect of future employment up to retirement age

ADJUSTED INCOME FROM EMPLOYMENT

Generally, expenses wholly and exclusively incurred in the production of employment income would rank for a deduction i.e. the incurrence of the expenditure must be directly linked to the generation of the gross income from employment. In the event the allowable expenditure exceeds the gross income from an employment, the excess can neither be carried forward nor be set off against other income.

Rent paid for the unfurnished accommodation or furniture provided is deductible but restricted to the value of accommodation and furniture included in gross income. In the MIT TAX I DEC 1999 Q3 (abstract), (see 3rd Quarter 2002 Issue), if Elias paid the employer rent of RM300 and RM4,000 per month for the furniture and the unfurnished accommodation respectively, his claim for the rent paid would be as follows:

: 300 X 10 months = RM3,000 but restricted

to RM2,800

Accommodation: 4,000 x 10 months = RM40,000 but

restricted to RM33,000

Entertainment expense is allowable if incurred in connection with the business of the employer. However, sec. 38A limits the allowable expense to the amount of entertainment allowance included in the gross income under sec. 13(1)(a). Any excess can neither be used as a tax loss nor be carried forward for future deductions

MIT TAX I PILOT PAPER Q3 (abstract)

Mr. Lim's employment income for 1993 included an entertainment allowance of RM500 per month up taxpayer 30th September 1993. He incurred RM5,000 to entertain the company's clients. His claim for deduction is restricted to RM4,500.

Travelling expenses incurred in the performance of his duties is allowable. In Newsom v Robertson, it was held that traveling from home to place of work is not allowable since it is to put in a position to produce income and not incurred in the production of income. However in FC of T v Weiner, travelling between venues of work was held to be allowable.

A payment to employment agencies is not allowable as established in Short v McIllgorm 26 TC 262 because it is to obtain an employment without which you cannot be producing employment income. Initial costs are not deductible. In AB [(1960) FB XXIII], judicial robes acquired on appointment as a judge was held to be not allowable as a deduction because they were not incurred in the production of income but rather to produce income.

Similarly, the cost of acquiring qualifications e.g. MIT, ACCA, MBA etc. is not allowable because it is an initial cost without which the employment cannot be obtained. Further, it is an enduring benefit thus making it a capital expenditure. The following cases illustrate the disallowances of this expenditure.

- Blackwell v Mills 26 TC 468, cost of evening classes even if they are imposed as a condition of employment
- Humbles v Brooks 40 TC 500 weekend lectures attended by a teacher to improve his knowledge of history
- Lupton v Potts 45 TC 643 examination fees paid by an articled clerk to sit for the Law Society's examination

However cost of training courses for maintaining technical efficiency may be allowable if the employment duties cannot be performed without incurring the particular expense. For example,

if an audit staff is sent for training on new accounting standards introduced, it is allowable because it enables him to keep abreast with the latest developments in accounting.

Private expenditure is not an admissible deduction. Thus, the cost of lunch, usual clothing maintenance of a home etc. would not rank for a deduction since they would be incurred anyway irrespective of whether there is an employment or not!

Professional subscriptions are allowable because it is to retain his professional qualification, which in turn enables him to earn income from his employment. However, only annual fees (and not entrance fees) qualify for a deduction because entrance fee is an enduring benefit i.e. a one-off lump sum payment.

In KPHDN v Dr. Arunjit Dutt (1995) 2 MSTC 3,454, the cost incurred in contesting an unjust dismissal from duties was held to be allowable.

Technical journals, magazines, renewal of reference books and replacement of instruments are generally allowable if they are actually required for the purpose of discharging employment duties. General reading materials would not rank for a deduction.

Expenditure on moisturizers, hair conditioners, shoes and hosiery were held to be deductible expense for a flight attendant in Mansfield v FC of T (1996) MSTC 9,003.

In FC of T v Edwards (94 ATC 4255), expenditure incurred on additional conventional clothing was held to be allowable for the secretary to the Governor's wife. This was because she was required to be attired differently at different engagements, which were numerous even in 1 day. Thus the expenditure was held to be used for work-related purposes as it enabled the secretary to join the Governor's wife at different types of functions.

This concludes the topic on the taxability of employment income. To summarise, you should now be able

- to differentiate between the exercise of an employment and a profession
- to recognize the significance of the differentiation
- to evaluate circumstances where employment income, though received overseas, is deemed to be derived from Malaysia
- to determine when the 60-day exemption rule would be applicable
- to understand the principles under section 25 relating to the basis of assessment of employment income, and
- to ascertain the gross income and adjusted income from an employment.

The Author Siva Nair holds an Honours Degree in Accounting from University of Malaya and an MBA (Acct). He is a Chartered Accountant (Malaysia) and a fellow of the Malaysian Institute of Taxation. He has gained extensive experience in the field of taxation whilst being employed in one of the big five firms and again as a Senior Finance and Tax Executive In an established property development company. Currently he is a freelance lecturer preparing students for the examination of ACCA, ICSA, MIT, MACPA, AIA and also tutoring undergraduates undertaking Accountancy Degree programmes in both local and foreign universities.

PRACTICAL EXERCISE:

Sanjeev who was a Malaysian resident aged 49 has been employed with Illiterate Technologies Sdn Bhd since 1st April 1995. In view of the company's business deterioration, he was retrenched with effect from 1st January 2003, receiving compensation of RM60,000 and a retiring gratuity of RM60,000. Justin subsequently migrated to Canada on 1st January 2003.

His remuneration for the period ended 31st December 2002 was as follows:

	RM
Salary (net of EPF of 11%)	4,450 p.m
Leave pay (paid on 31.12.02 for January & February 2003)	3,000 p.m
Bonus (paid on 31.7.02 for the period 1.7.01 - 30.6.02)	18,000
Medical treatment for his wife	3,800
Travelling allowance (up to 31.12.2002)	900 p.m
Entertainment allowance (up to 31.12.2002)	700 p.m
Gardener (provided and paid for the company)	500 p.m
Servant (employed by Sanjeev but reimbursed by the company) (up to 31.10.2002)	600 p.m

Other details:

1) Up to 31st December 2002, he is provided with a car, acquired new by the company in 1996 for RM105,000, a

- driver employed by the company at RM500 p.m. and all petrol expenses are borne by the company.
- 2) A fully furnished bungalow, which the company rented for RM1,200 p.m. was provided up to 31st October 2002. The rental included RM300 p.m. for the furniture but Justin was required to pay RM150 p.m. to the company. From 1st September 2002 he was placed at a hotel where the daily room rate was RM200.
- 3) Sanjeev and his family went on two all expense paid holidays with details as follows:

	Canada RM	Japan RM
Airfare	5,000	2,000
Hotel and food	3,000	2,000

- 4) Sanjeev incurred travelling and entertainment expenses totalling RM9,000 and RM8,600 respectively for official reasons
- 5) He withdrew all the amount from an unapproved fund set up by the company amounting to RM22,000 comprising:

	RM
Employer's contribution	12,400
Employee's contribution	9,600

Required:

Calculate the adjusted income from employment for Sanjeev for the year of assessment 2002.

FURTHER READING

1. Veerinderjeet Singh (2001), Malaysian Taxation — Administrative and Technical Aspects 5th Ed., Kuala Lumpur, Longmans Malaysia. Chapter 7 2. CCH Tax Editors (2002), Malaysian Master Tax Guide 19th Ed, Singapore, CCH Asia Ltd. Paragraphs 800 - 856



TIME TABLE FOR THE MIT EXAMINATION FROM 16 - 20 DECEMBER 2002

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^{*}Including 10 minutes reading time.

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