Malaysian Institute Of Taxation

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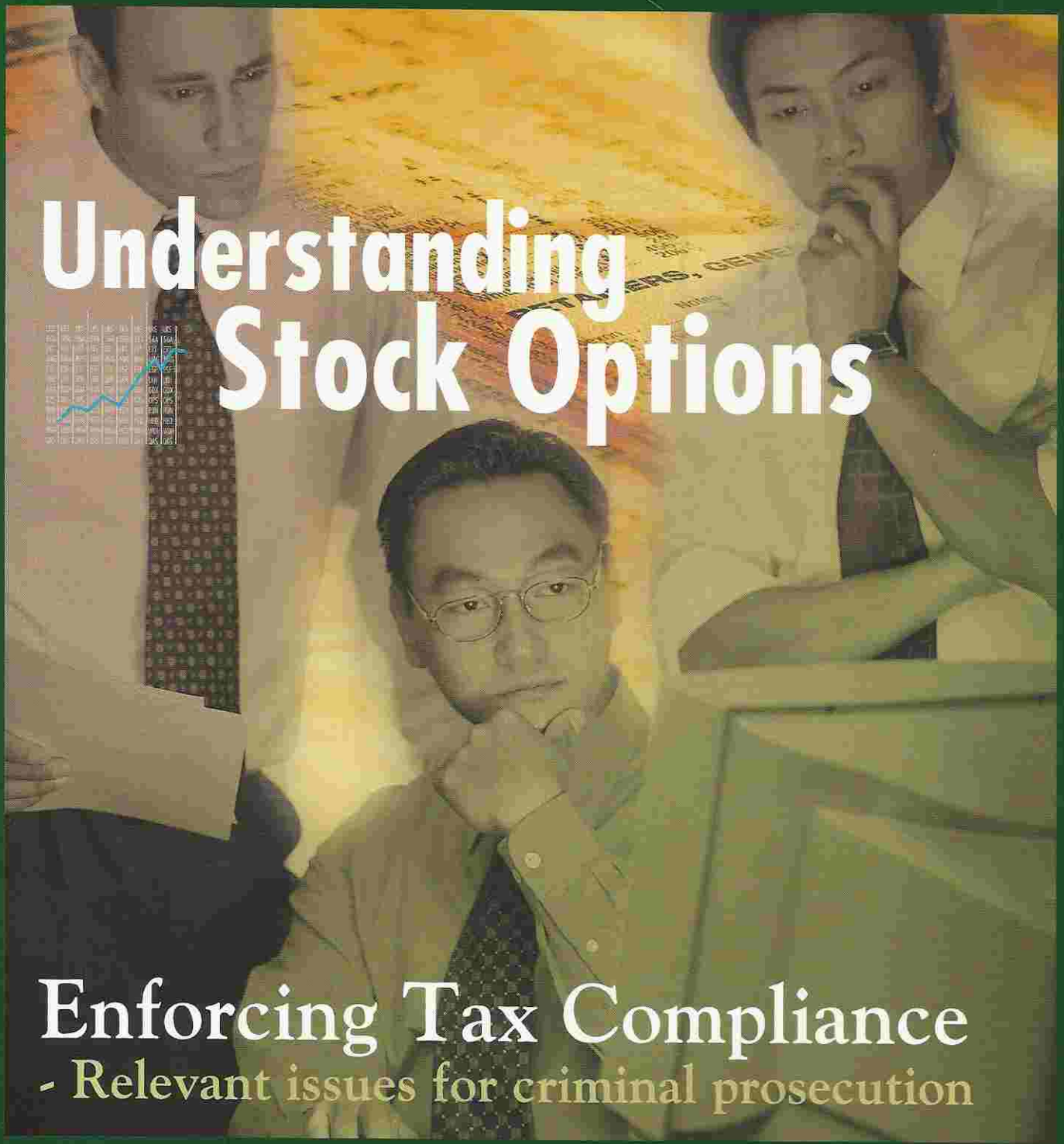

Understanding Stock Options

Enforcing Tax Compliance
- Relevant issues for criminal prosecution

CCH

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How to become a member of the Malaysian Institute of Taxation

Malaysian Institute Of Taxation
http://www.mit.org.my

BENEFITS AND PRIVILEGES MEMBERSHIP

The Principal benefits to be derived from 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.
- Obtain of the Annual Tax Review together with the Finance Act.
- Opportunity to take part in the technical and social activities organised by the Institute.

CLASSES OF MEMBERSHIP

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.T.I.I.), and in the case of an Associate the letters Associate of Taxation Institute, Incorporated (A.T.I.I.).

Qualification required for Associate Membership

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 taxation matters approved by the Council.

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 taxation 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.

5. 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.

6. Any person who is registered with MIA as a Chartered Accountant without Practising Certificate and has had not less than three (3) years practical experience in practice or employment relating to taxation matters approved by the Council.

7. Any person who is registered with MIA as a Licensed Accountant and who has had not less than five (5) years practical experience in practice relating to taxation matters approved by the Council after admission as a licensed accountant of the MIA under the Accountants Act, 1967.

8. Any person who is an approved Tax Agent under Section 153 of the Income Tax Act, 1967.

Fellow Membership

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.

APPLICATION FOR MEMBERSHIP

Every applicant shall apply in a prescribed form and pay prescribed fees. The completed application form should be returned accompanied by:

1. Certified copies of:
   (a) Identity Card
   (b) All educational and professional certificates in support of the application
2. Two identity card-size photographs.
3. Fees:

	Fellow
(a) Upgrading Fee	*RM300*
(b) Annual Subscription	*RM200*
	Associate
(a) Admission Fee	*RM200*
(b) Annual Subscription	*RM150*

Every member granted a change in status shall thereupon pay such additional fee for the year then current as may be 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 for 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 31 of each year.

The President's Note

It is the year of the "Monkey" and it has been forecasted by many to be a year of prosperity and goodwill for the nation and its people. From the headlines of some of the major dailies in January 2004, it appears that 2004 will be a productive year for the tax office.

In January 2004, there was a flurry of headlines on the current activities of the Inland Revenue Board (IRB), to entice deviant taxpayers to lodge their annual tax returns. The Director General did not mince words, when he clearly indicated his intention to pursue tax dodgers and no "political clout" will be entertained to evade the payment of taxes.

As President of the Institute, I have on numerous occasions mentioned that it is fundamental that we accept our duty to pay tax, as there is only so much in terms of patience and tolerance that a revenue authority can bear.

The actions by the IRB may be seen by many as draconian and flamboyant, but I am of the opinion, that compelling steps were needed to be taken, to illustrate that the Board is serious in its intention to ensure a 100 per cent compliance of tax laws.

...compelling steps were needed to be taken, to illustrate that the Board is serious in its intention to ensure a 100 per cent compliance of tax laws.

There have been numerous warnings by the Director General in the last three years of his intention to come down hard on errant taxpayers, for instance, such a caution was mentioned to members, at the MIT Luncheon with the DGIR on 2nd September 2003.

It must be highlighted that the IRB does not stand to directly benefit from the improvement in tax compliance, as it is in fact, the *rakyat* of the country that will stand to directly benefit from the increase in government revenue, as there will be a reduction in tax rates as well as, improvement in domestic infrastructure and policies.

However, I do want to assure members of the Institute, that the Institute has been monitoring the actions of the Board and has been consistently advising the Inland Revenue Board to consider all factors when taking action against a taxpayer as there may be mitigating factors to be considered.

It is also imperative, that members do advise their clientele or employers, of the need to ensure adequate and timely compliance, as well as, to advise the Institute if there are any inconsistencies in the mode and manner upon which the tax laws are duly enforced by officers of the Board.

To conclude, the Director General has in numerous occasions, advised the common taxpayer of the Board's intention to enforce the laws of the nation, not with the intention to penalize, but more as part of the ultimate objective of the IRB to ensure that the correct amount of tax is collected within the stipulated timeframe.

Which is in essence, the fundamental reasoning for self assessment.

I wish to end by wishing all members a prosperous and exciting year 2004, and hope that it will be a year of good returns and easy collections.

Ahmad Mustapha Ghazali
PRESIDENT

The Editor's Note

The New Year begins with a visit by MIT representatives to the Institute of Certified Public Accountants Singapore (ICPAS). It is hope that this visit will strengthen bilateral tie between the Institute and ICPAS. The coverage of the visit has been included in the Institute News.

Also under the Institute News, we have covered the dinner event hosted by the Institute in conjunction with the CATA conference, the Budget Booklet dinner and the Hari Kualiti Kastam.

Other articles of interest include:

Understanding stock options

A brief discussion on stock option schemes by Karen Tan and Lim Thien Sen highlighting the key features, tax implication and regulatory requirements on an employee share option scheme.

Enforcing tax compliance

The tax authorities are coming down hard on taxpayers who have committed tax fraud and non-compliance of tax regulations under the Self Assessment System as pointed out by Dr. Sivamoorthy Shanmugam in this article. This article looks into offences that may lead to criminal prosecutions, common fraudulent practices undertaken by taxpayers and the action taken by the tax authorities to deter efforts of these tax offenders.

Estimating the Extent of Income Tax Non-Compliance in Malaysia and Australia Using the GAP Approach

Dr. Mohani Abdul and Prof. Peter Seehan continue their discussion from the previous issue on the extent of non-compliance in Malaysia and move on to look into the two potential reasons for the low ratio of actual to derived taxable income.

Transfer pricing aspects for business

Dr. Arjunan Subramaniam offers us an insight on how the tax authorities can act against transfer pricing policies viewed as tax avoidance schemes together with illustrations on the methods available in IRB's transfer pricing guidelines and references are made to cases of transfer pricing in other countries.

Free Zones – A Boost for Export Oriented Industries

Free Zones play an important role in international trade especially with its simplified export and import procedures. Thomas Selva Doss provides an explanation on the operations of the Free Trade Zone and how they facilitate international trade.

A Taxing Passage

The deductibility of leave passage as a business expense has been receiving much attention recently. As it is becoming a common feature in remuneration packages, Nakha Ratnam examines the ruling issued by the authorities governing leave passage, which include review of cases and the conflict in law.

Malaysia-Economic Recovery

An overall view of the road to recovery for the Malaysian economy since the financial crisis. Dr. A. Thillaisundaram looks into the effort undertaken by the Government to revive the economy back to the pre-crisis era and the extent the measures have worked for the growth of the economy.

Learning curve

In this issue, Siva Nair explains the taxability of business income by looking into the description of business income and analysing the various badges of trade.

Harpal S. Dhillon
Editor of Tax Nasional

Malaysian Institute Of Taxation

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

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Tax Nasional

Official Journal of the Malaysian Institute of Taxation

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Contents

1st Quarter 2004

Note : The views expressed in the articles contained in this journal are the personal views of the authors. Nothing herein contained should be construed as legal advice on the applicability of any provision of law to a given set of facts.

Dinner For CATA Delegates

The Malaysian Inland Revenue Board (IRB) played host to the 24th Commonwealth Association of Tax Administrators (CATA) Technical Conference held from 8 to 12 December 2003. Tax administrators from the commonwealth countries attended this technical conference which is held annually at the different commonwealth countries.

In conjunction with the international conference, the Malaysian Institute of Taxation hosted a dinner for the CATA delegates at the Kuala Lumpur Tower on 9 December 2003. The dinner was hosted in the spirit of further enhancing the relationship with the IRB and the tax authorities from the commonwealth countries.

The international delegates were treated to a sumptuous spread of traditional Malaysian cuisine and was accompanied by live musicians in the background. The highlight of the night was the photography session of the delegates clad in the Malay traditional costumes.

YBhg Tan Sri Zainol Abidin bin Abdul Rashid with a delegate, taking a view of Kuala Lumpur city from the observation deck of KL Tower.

The MIT President, En Ahmad Mustapha Ghazali and wife, Pn Narimah Mohd. Perai welcoming the Director General of IRB, YBhg Tan Sri Zainol Abidin and wife, Pn Sri Azizah Arub at the entrance of the KL Tower.

Tan Sri Zainol Abidin bin Abdul Rashid and wife, Pn Sri Azizah Arub with some of the international delegates at the observation deck of the KL Tower.

Appreciation Dinner

Mr Beh Tok Koay, President of the MICPA addressing the floor

Co-Chairman, Mr Poon Yew Hoe presenting the prize to one of the winners of the lucky draw.

A dinner was held in appreciation of the team involved in the publishing of the 2004 Budget Commentary & Tax Information Booklet on 10 November 2003. The dinner was jointly organised by Malaysian Institute of Taxation, Malaysian Institute of Accountants and the Malaysian Institute of Certified Public Accountants, and was held at Sheraton Imperial Hotel, Kuala Lumpur.

Co-Chairman of the project, Mr Harpal Singh in his opening address extended his appreciation to the team responsible for the inception and the birth of the booklet. Furthermore he added that the 2004 Budget Commentary and Tax Information Booklet project was yet another resounding success to add on to the achievements of the three professional bodies involved.

At the dinner, Mr Beh Tok Koay, President of MICPA addressed and thanked the team that successfully produced the Budget Booklet.

A lucky draw was held during the dinner, and prizes to winners were given by Co-Chairman, Mr Poon Yew Hoe.

From right to left: Mr Gurbachan Singh, Mdm Teoh Lian Nee, Mr Tan Boen Eng (President of ICPAS), Mr Noris Ong, Mrs Angela Tan and Mr Ramchand N Jagtani

Visit To ICPAS

The Malaysian Institute of Taxation (MIT) paid a courtesy visit to the Institute of Certified Public Accountants of Singapore (ICPAS) on 7th January 2004. MIT was of the opinion that such a visitation, will serve to strengthen bilateral ties between the ICPAS and MIT, as well as, to provide an opportunity to discuss a number of issues relating to the practice of tax within the ASEAN region.

MIT was represented by Deputy President, Tuan Haji Abdul Hamid and Vice President, Dr Veerinderjeet Singh. The MIT delegation was received by the ICPAS President, Mr Tan Boen Eng and a number of prominent Singaporean tax practitioners and academicians.

The meeting commenced with an extension of greetings and welcome from both the ICPAS and MIT, and proceeded with a short briefing on the recent activities of both Institute's.

MIT was informed by the ICPAS of its recent efforts to significantly improve the value added services provided to Singaporean tax practitioners, upon which the MIT replied with an open offer of support to the ICPAS, in its current policy to improve representation of Singaporean tax practitioners.

The meeting then proceeded to discuss the issues affecting the practice of tax within the ASEAN region and after considering the close resemblance in tax systems, it was agreed that the ICPAS and MIT should consider an annual dialogue between Institute's so as to create an annual platform for the discussion of practice issues between the ICPAS and the MIT.

The delegates then discussed the possibility of the establishment of an ASEAN tax forum, comprising of tax organisations/institutes within the ASEAN region.

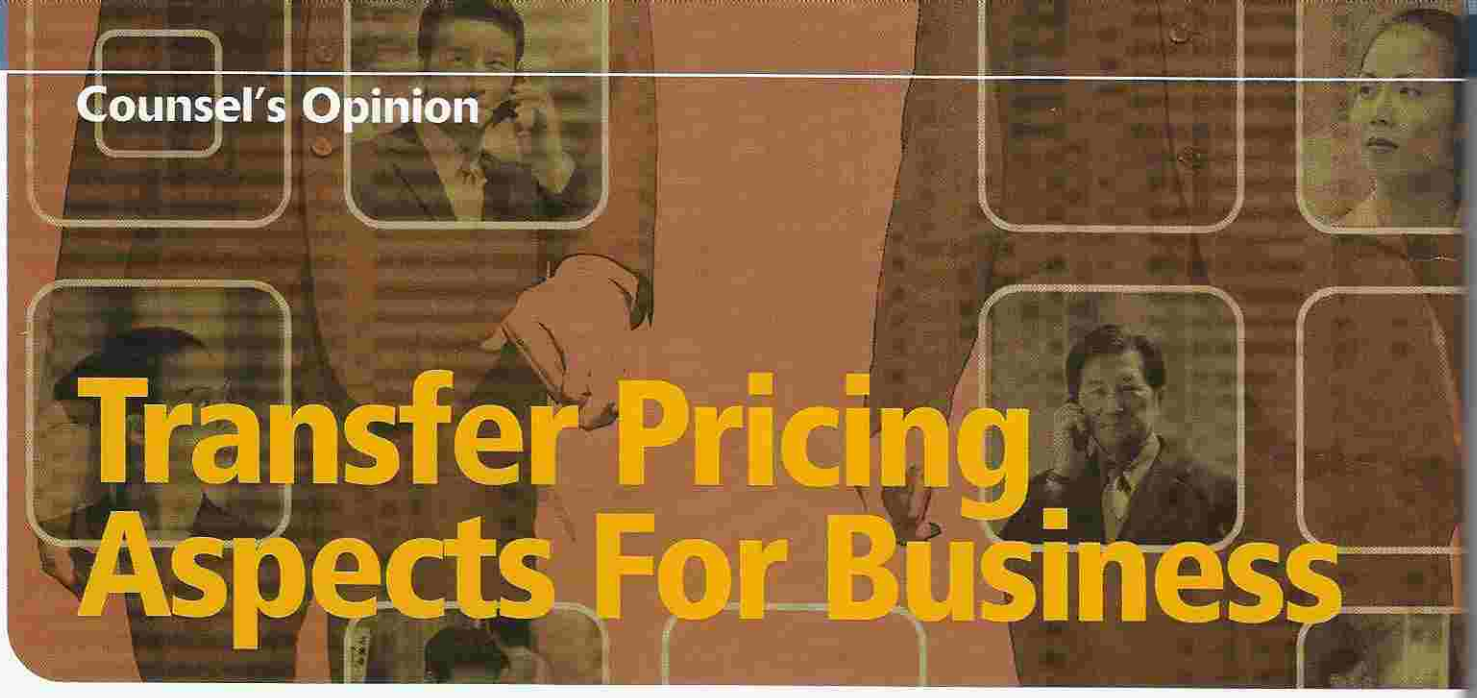
The meeting was concluded with a note of thanks by Tuan Haji Abdul Hamid for the warm reception extended by the ICPAS as well as with an invitation to President Tan Boen Eng (ICPAS President), to visit the MIT in Kuala Lumpur.

HARI KUALITI KASTAM

The Royal Customs Department recently held a "Majlis Sambutan Hari Kualiti dan Perhimpunan Setia & Mesra" on 4 December 2003 at the headquarters in Putrajaya.

Tuan Haji Abdul Hamid bin Mohd Hassan, the Deputy President of MIT led the private sector in taking the oath at the function.

Tuan Haji Abdul Hamid, at the ceremony with Tan Sri Dato' Paduka Abdul Halil bin Abd Mutalib, Director General of Royal Customs Malaysia.



Transfer Pricing Aspects For Business

By DR ARJUNAN SUBRAMANIAM

1. Transfer Pricing
– Meaning and Targeted Effect

Transfer pricing, as the name implies, is to achieve tax advantages by a system of pricing and other payment terms with a predetermined objective of reallocating profits in tax jurisdictions where the incidence of tax is NIL or lower. Essentially, transfer pricing policies which are attacked by tax authorities are tax avoidance schemes and do not fall into the category of "tax mitigation".

"Tax mitigation" is when a taxpayer reduces his income or incurs expenditure in circumstances, which reduces his income or entitles him to a deduction. As Lord *Tomlin* said in *I.R.C v. Duke of Westminster [1936] AC1.*

"Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Act is less than it otherwise would be."

But such an achievement is allowed so long it does not fall under the provisions in sec. 140 and 141 of the *Income Tax Act 1967* that is "tax avoidance".

2. The Legislation
– Provisions in the Income Tax Act 1967

The Revenue has powers under sec. 140 of the *Income Tax Act 1967* to disregard certain transactions where a transaction has the effect of –

a. altering the incidence of tax which is payable or suffered by or which would otherwise have been payable or suffered by any person;

b. relieving any person from any liability which has arisen or which otherwise has arisen to pay tax or to make a return;

c. evading or avoiding any duty or liability which is imposed or would otherwise have been imposed on any person by this Act; or

d. hindering or preventing the operation of this Act in any respect,

may, without prejudice to such validity as it may have on any other respect or for any other purpose, disregard or vary the transaction and make such adjustment as he thinks fit with a view to counteracting the whole or any part of any such direct or indirect effect of the transaction.

New computations – section 140(2)

In exercising his power under this section, the Director General may –

a. treat any gross income from any source of any person either as the gross income and source of any other person, or where the gross income is that of a controlled company, as having been distributed to any member [within the meaning of sec. 139 (7)] of that company;

b. make such computation or recomputation of any gross income, adjusted income or adjusted statutory income, aggregate income, total income or chargeable income of any person or persons as may be necessary to revise any person's liability to tax or impose any liability to tax on any person in accordance with his exercise of those powers; and

c. make such assessment or additional assessment in respect of any person as may be necessary in consequence of his exercise of those powers, nullify a right to repayment of tax or require the return of a repayment of tax already made.

Power of Director General – section 140(3)

Without prejudice to the generality of the foregoing subsection, the powers of the Director General conferred by this section shall extend –

a. to the charging with tax of any person or person who but for any adjustment made by virtue of this section would not be chargeable with tax or would not be chargeable with tax to the same extent; and

b. to the charging of a greater amount of tax than would be chargeable but for any such adjustment.

Notice to taxpayer
– section 140(4) Repayment to Director General
Where in accordance with this section the Director General requires from a person the return of the amount of a repayment of tax already made –

a. the Director General shall give to that person a notice of that requirement and the notice shall be treated as a notice of assessment for the purpose of any therefrom, the provisions of chapter 2 of Part VI applying with any necessary modifications; and

b. that amount shall be deemed to be tax payable under an assessment and sec. 103 and the other provisions of Part VII shall apply accordingly.

Particulars of adjustment – section 140(5)
Where in consequence of any adjustment made under this section an assessment is made, a right to repayment is refused or a return of a repayment of tax is required, particulars of the adjustment shall be given with the notice of assessment, with the notice refusing the repayment or with the notice requiring the return of a repayment, as the case may be.

Controlled transactions – section 140(6)
Transactions –

a. between persons one of whom has control over the other;

b. between individuals who are relatives of each other; or

c. between persons both of whom are controlled by some other person,

shall be deemed to be transactions of the kind to which subsection (1) applies if in the opinion of the Director General those transactions have not been made on terms which might fairly be expected to have been made by independent persons engaged in the same or similar activities dealing with one another at arm's length.

Transaction by non-residents – section 141(1)
Where a non-resident conducts business with a resident under circumstances where the non-resident has control over the resident and such relationship produces no income or a smaller income to the resident, the non-resident is deemed to have a chargeable income charged in the name of the resident.

If the non-resident income is not readily ascertained, the Director General can take a fair and reasonable percentage of the turnover of the business of the non-resident through or with the resident. [Section 141(2) (a)].

Under sec. 141(2)(b), a resident is required to furnish the tax return of the non-resident to Director General. Section 141 – does not apply where a resident controls the non-resident or when both are controlled by a third party. In such situations, the Revenue would have recourse under the general sec. 140 of the *Income Tax Act 1967*.

3. Wilful Evasion
– section 114 of the Income Tax Act 1967.
Note that a transfer pricing policy can amount to wilful evasion.

4. The Guidelines
– Transfer Pricing Guidelines
The Inland Revenue Board has issued guidelines in respect of Transfer Pricing. Essentially, the guidelines advocate "an arm's length transfer price". The guidelines are applicable to cross-border transactions and as well as domestic transactions between associated companies. The following methods are listed in the guidelines:

a. comparable uncontrolled price method,

b. resale price method,

c. cost plus method,

d. profit split method, and

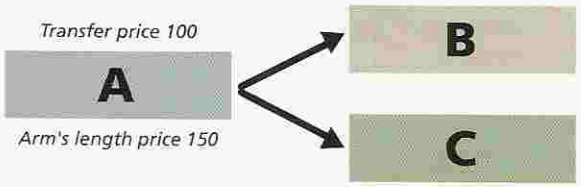
e. transaction net margin method

] other methods

A brief description of the above methods given in the guidelines is as follows:

4.1 Comparable Uncontrolled Price (CUP) Method
The CUP method is ideal only if comparable products are available, or if reasonably accurate adjustments can be made to eliminate material product differences. Other methods will have to be considered if material product differences cannot be adjusted to give a reliable measure of an arm's length price.

4.2 Example:
Taxpayer **A**, an MNE sells 70% of its product to an overseas associated company **B**, at a price of RM100 per unit. At the same time, the remaining 30% of the products are sold to a local independent enterprise **C** at RM150 per unit.



The products sold to B and C are the same. The transaction between A and C may be considered as a comparable uncontrolled transaction. However, a functional analysis of B and C must first be carried out to determine any differences. If there are differences, adjustments must be made to account for these differences. Adjustments must also be made to account for different market conditions since B and C are located in different countries and for product quantity discounts since volume of sales to B and C are not the same. Assuming that reasonable accurate adjustments can be made to eliminate the material effects of these differences, then the CUP method may be applied using the unit price of RM150 as a comparable arm's length price.

Author's comment:

In the above example, the accuracy of the method depends on the accuracy of the arm's length price of RM150. It follows that empirical data is still essential as a focus point from which adjustments need to be made. In addition, differences in quantity sold, market conditions and terms of payment need to be evaluated.

4.3 Resale Price Method

4.3.1 The resale price method is generally most appropriate where the final transaction is with an independent distributor. The usefulness of the method largely depends on how much added value or alteration the reseller has done on the product before it is resold, or the time lapse between purchase and onward sale. The method is more difficult to apply if the product has gone through a number of processes and the time lapse is too long (to the extent that market conditions might have changed) before it is resold or, when the reseller contributes substantially to the creation or maintenance of an intangible property that is attached to the product.

The starting point in the resale price method is the price at which a product that has been purchased from an associated enterprise is then resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin (the resale price margin) representing an amount from which the reseller would seek to cover its selling and other operating expenses and in the light of functions performed (taking into account assets used and risks assumed), make an appropriate profit. An arm's length price for the original transaction between associated enterprise is obtained after subtracting that gross margin, and adjusting for other costs associated with the purchase of the product (e.g. custom duties). A typical adjustment may be represented as follows:

As shown in the formula, the focus is on the resale price margin. This margin should ideally be established from comparable transaction between the reseller (involved in the controlled transaction) and other independent parties.

Arm's length price = Resale price – (resale price x resale price margin)

Where:

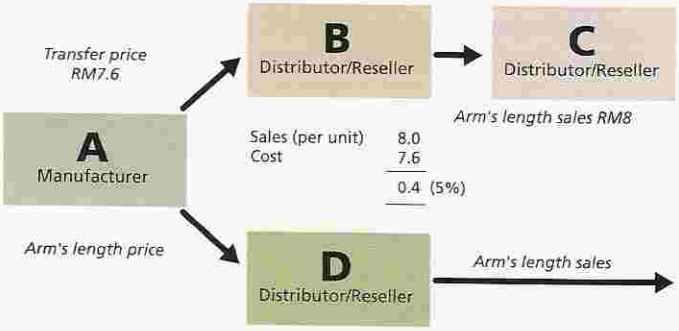
$$\text{* Resale price margin} = \frac{\text{Sales price} - \text{purchase price}}{\text{Sales price}}$$

* Resale price margin must be comparable to margins earned by other independent enterprises performing similar functions, bearing similar risks and employing similar assets.

4.4 Example:

Taxpayer B is a Malaysian subsidiary of multinational A, which is located overseas. B is a distributor of a high quality product manufactured by A. A also sells a similar product of a lower quality to an independent distributor D in Malaysia. The cost of product purchased from A by B is RM7.6 per unit. B resells the product to independent party C for RM8. Based on functional analysis, it was found that functions performed by B are similar to that of D. The gross profit ratio of D was found to be 10%.

In this example, it is noted that there are product (quality) differences when comparing the controlled and uncontrolled transactions. However, since the focus of comparison is on margins, the differences are not material, as they would have been if the basis of



comparison were on prices. Furthermore, functions carried out by B and D are similar (D being another reseller in the same market). Thus the resale price margin of 10% will be used as a basis to determine the arm's length price for the original purchase by B from A. Arm's length price of product purchased (in RM) = 8 – (8x10%) = 7.2

Author's comment:

In this example, reliance is placed on a predetermined transfer price of 10% resale price margin. If this "standard price" is inaccurate, the whole exercise in transfer pricing will be under suspicion. It is imperative then to have valid "sign post" of non-controlled prices. Analysis is still required of the other variable factors which determine price such as quantity, quality, differences in design etc.

4.5 Cost Plus Method

4.5.1 The cost plus method is often useful in the case of semi-finished goods, which are sold between associated parties, or when different companies in an MNE have concluded joint facility arrangements, or when the manufacturer is a contract manufacturer, or where the controlled transaction is the provision of services.

The starting point in a cost plus method, in the case of transfer of products between associated parties, is the cost to the supplier. An appropriate mark-up is added to this cost to find the price that the supplier ought to be charging the buyer. The appropriate mark-up should ideally be established by reference to the mark-up earned by the same supplier from comparable uncontrolled sales to independent parties, due to the fact that similar characteristics are more likely found among sales of product by the same supplier, than among sales by other suppliers. If no such transactions exist, the appropriate mark-up may be determined based on comparable transactions by independent parties operating independently. If there are material differences between the controlled and uncontrolled transaction that could affect the gross profit mark-up, appropriate adjustments must be made on the gross profit mark-up earned in the uncontrolled transaction.

Formula for adjustment:

Arm's length price = Cost + (cost x cost plus mark-up)

Where:

$$\text{* Cost plus mark-up} = \frac{\text{Sales price + costs}}{\text{Cost}}$$

* Cost plus mark-up must be comparable to mark-ups earned by independent parties performing comparable functions, bearing similar risks and employing similar assets.

4.6 Example:

Taxpayer B is a Malaysian subsidiary of foreign multinational A. B manufacturers electrical components, which is exported to A. The electrical components are specially tailored to meet the requirements of A. All raw materials used in the manufacture of the product are purchased from an independent enterprise C, at RM20 per unit. The total cost per unit of manufactured product is RM80. B then sells the product to A at a price of RM100 per unit. A similar (unassociated) manufacturing company that sells to an independent company is found to have a mark-up of 40%.

Since the product is an extensively customized product, there are no product comparables. The mark-up of 40% from the other manufacturing company performing the same functions, bearing similar risks and using similar assets, can be used as a basis in arriving at an arm's length price.

Arm's length price RM20

Sales		100
Purchases	20	
Mfg cost	50	
Overheads	10	80
G.P		20

Arm's length price of electrical component sold to A by B (in RM)
= 80 + (80 x 40%)
= 112

Author's comment:
Note clearly in this example as with the other two examples "the mark up of 40%" is assumed as correct. In any transfer pricing exercise evidence of reliable data need to be presented to expert witness in the field. Transfer pricing exercise cannot succeed without empirical study of market forces, prices and cost.

5. Agreements for the avoidance of Double Taxation

– the permanent establishment and exchange of information

There are provisions in the Double Taxation (Relief) Agreements which relates to the arm's length principle. The Australian Agreement is cited here as an example. Article 7, para. 2 of the *Double Taxation Relief (Australia) Order 1980* provides that –

"where an enterprise of one of the Contracting States carries on business in the other Contracting States through a permanent establishment situated therein, there shall in each Contracting States be attributed ***to that permanent establishment the income or profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment*** *or with other enterprise with which it deals."*

Paragraph 3 of the same Article provides that –

"In the determination of the income or profits of a permanent establishment, there shall be allowed as deductions expenses of the enterprise, being expenses (including executive and general administrative expenses) which are reasonably connected with the permanent establishment and which would be deductible ***if the permanent establishment were an independent entity that incurred those expenses,*** *whether incurred in the Contracting States in which the permanent establishment is situated or elsewhere."*

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- Managers
- Finance Managers

The Speaker

Chow Chee Yen is a Fellow Member of the Chartered Association of Certified Accountants (FCCA), an Associate Member of the Malaysian Institute of Taxation (ATII) and a Chartered Accountant of the Malaysian Institute of Accountants (CA).

He is also a graduate of the Malaysian Institute of Certified Public Accountants (MICPA) Examinations and successfully completed the Certified Financial Planner (CFP) conversion programme.

He is currently an Associate Director with an international firm in Kuala Lumpur, specialising in corporate taxation. He has more than 11 years of tax experience and was involved in tax engagements concerning cross border transactions, tax due diligence review, restructuring schemes, corporate tax planning, group tax review and inbound investments.

He is also involved in tax workshops and seminars organised by MIA and MIT on a regular basis. In addition, he has been lecturing extensively in various colleges and university in the Klang Valley for the past 8 years, specialising in taxation papers for professional examinations namely ACCA, MICPA, ICSA and MIT. He was also the Chief Examiner for a taxation paper of a professional examination body.

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Corporate Tax Planning

- Objectives of corporate tax planning
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Workshop 2 — 24 Apr 2004, Saturday

Developments and Updates on Budget Proposals for the last six YA's

- Gazetting of Budget Proposals
- Tax implications and salient feature of Gazette Orders
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- Latest Gazette Orders and Finance Act

Workshop 3 — 15 May 2004, Saturday

Taxation for Construction Companies & Property Developers, and Tax Implications on Shares in Real Property Companies

- Accounting treatment for construction companies and property developers
- Tax treatment for construction companies and property developers
- Common issues raised by the IRB
- IRB Guidelines for construction companies and property developers
- The concept of Real Property Company
- Acquisition price of Real Property Company shares
- Date of acquisition of Real Property Company shares
- Practical issues on Real Property Company shares
- Tax planning for Real Property Company shares

Workshop 4 — 29 May 2004, Saturday

Tax Considerations for Merger and Acquisitions and Initial Public Offer (IPO)

- Tax implications on transfer of assets
- Tax implications on transfer of shares
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- RPGT exemptions
- Tax planning for merger and acquisitions
- Tax planning for IPO exercise

Workshop 5 — 19 Jun 2004, Saturday

Tax Planning for Cross Border Transactions and Double Tax Treaties

- Types of holding structure for foreign investments
- Advantages and disadvantages of various holding structures
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- Repatriation of profits
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It is clear that the arm's length principle can and must be applied where Double Taxation (Relief) Agreements operate. To establish correct price, and to avoid the loss of tax, the authorities of the contracting parties may exchange information.

Article 25, of the Australian Agreement provides for exchange of information for the prevention of fraud or for the administration of statutory provisions against legal avoidance.

6. Scope of the Arm's Length principle

a. An anti-avoidance provision substitutes market value for the consideration to avoid loss of revenue by parties suppressing the actual consideration.

b. If a transaction is not between connected persons, and the consideration is inadequate, the transaction can still be examined **to see if any benefits accrue to a party in an apparent unrelated agreement and such a benefit may accrue in a low tax jurisdiction.**

c. Likewise, where parties to an agreement are related, that relationship alone cannot be taken to mean that the consideration is inadequate, that is, not at arm's length. If the consideration can be defended as the 'market value' then it is absurd to strike at the consideration and attempt to substitute it with an alleged 'market value'.

d. A scheme must result in a real loss and not an artificial or arithmetical loss in which case the arm's length principle would apply and the stated consideration is substituted with the 'market value'. [See *Commissioners of I.R v. Burmah Oil Co. Ltd 54 TC 200*].

7 Malaysian Experience

Experience has shown that those indulging in transfer pricing policies to a tax advantage attempt to transfer profit to a tax haven or a tax jurisdiction with a NIL tax rate or a lower tax rate.

Thus, in a specific case;

a. goods were shipped from Australia to Malaysia, but

b. billing with higher prices was done by a company in the Bahamas,

c. the net effect was to transfer profit or a major part of profit to Bahamas, a low or NIL tax jurisdiction.

The Australian tax authorities provided and exchanged information with the Malaysian tax authorities on all the transactions, which resulted in the multinational in having to pay more taxes in Malaysia (and Australia). There are no case laws specifically on transfer pricing in Malaysia.

8 United Kingdom Experience

– cheating the public Revenue: R v. Charlton & Ors [1996] STC 1418

The facts in this case were:

"The defendants, an unqualified accountant, a barrister and two chartered accountants, were charged on an indictment with various counts of cheating the public revenue. The Crown's case was that the first defendant had devised a dishonest tax avoidance scheme for the benefit of some of his firm's clients and that the four defendants had been involved with the implementation of the scheme of the concealment from the Revenue of the existence of the fraud. There were two schemes (with some variations in individuals cases), which were the subject of the prosecution. The first, where the client (T Ltd) was a United Kingdom company, which purchased goods from overseas suppliers as part of its trade, involved the interposition of an offshore company to buy the goods from the overseas supplier and then resell them to T Ltd at a higher price. The difference, after the first defendant's fees had been paid, would be retained for the benefit of the beneficial owners of the offshore company, who were T Ltd's directors. The result was that T Ltd made a lower profit and thus reduced its liability to corporation tax. For the scheme to be tax effective, the offshore company had to be controlled and administered in Jersey by directors who were not resident in the United Kingdom and had to be independent of T Ltd. In fact, management and control of the offshore company remained in the hands of T Ltd's directors. T Ltd continued to purchase the goods from the overseas suppliers and delivery was made directly to T Ltd. The only function of the offshore company was to process the invoices, for which it charged high fees. The second scheme again involved an offshore company based in Jersey to which commission was paid by a company resident in the United Kingdom, either for non-existent services or for services at an inflated price. That offshore company was controlled by the directors of the United Kingdom company and the resulting financial benefits (after the first defendant's fees had been paid) accrued to them."

Transfer pricing, if not attempted with reasonable basis close to 'market value' in the circumstances of the case can lead to ...C was convicted on counts 1 to 11 and sentenced to five years' imprisonment ... etc.

9 Canadian Experience

– Indalex v. The Queen 86 DTC 6039.

In this case the facts were:

Pillar Aluminum purchased billets from an unrelated company, Alcan, and sold to Indalex a related company at the same prices. But Pillar secured the benefits of discounts and rebates from Alcan under other arrangements. The Court concluded that the price paid by Indalex was excessive. In these circumstances the profit spread justified by Pillar was held to be 1% rather than 5%.

In ***Spur Oil v. The Queen 81 DTC5168***, a US oil producer **Murphy** controlled **Spur Oil** and sold crude oil to it through an offshore subsidiary, **Tempin.** The Revenue disallowed the portion of the price paid by Spur Oil to Tempin which represented the latter's profit margin. The Court held that sec. 137(1) of the *Canadian Income Tax Act* did not prevent someone from generating the same profit from a transaction

with an affiliate as it would from a similar transaction with a third party with whom it was dealing at arm's length. Such a transaction would only attract the prohibition when the taxpayer's cost of crude oil supply, by reason of an act of the taxpayer or those controlling it, increased above the cost prevailing in the industry at the same time and under similar circumstances. Such an event did not occur in this case.

10. The U.S Experience

– Elilly & Co v. Commissioner of Internal Revenue 83 TC 996.

In this case, a U.S parent company transferred valuable intangibles to its subsidiary in Puerto Rico. The subsidiary manufactured goods for sale to the parent company. The parent company marketed the goods in the U.S. It was held:

a. in determining the arm's length principle the ownership of the intangibles by subsidiary must be recognised, and

b. the prices the subsidiary charged the parent caused a distortion and it followed that the prices must be adjusted.

c. The Inland Revenue adjustment of price did not recognise the return on ownership of the tangibles by the subsidiary and, therefore, cannot be accepted.

d. The taxpayer's resale price method of a full return on the tangibles was also rejected.

e. The Court applied a 'profit split method', which recognized:

   i. the ownership of the tangibles by the subsidiary, and

   ii. location savings of manufacturing in Puerto Rico rather than the U.S, as belonging to the subsidiary,

f. 100% profit on manufactured goods was allowed to the subsidiary on manufacturing costs and 100% profit to the parent on its marketing cost.

11. Bausch & Lomb, Inc v. Commissioner 92 TC 525

The facts were:

Two related companies Bausch & Lomb, Inc ("B&L, U.S"), a United States resident manufacturer and distributor of contact lenses, and Bausch & Lomb Ireland Ltd ("B&L Ireland"), an Irish resident manufacturer of contact lenses had the following transactions:

a. a 5% royalty charged by B&L (U.S) to B&L (Ireland) in respect of manufacturing intangibles transferred to B&L Ireland.

b. The transfer price of contact lenses manufactured by B&L Ireland and sold to B&L (U.S)

At issue was the transfer prices for both transactions and, whether B&L Ireland was acting as a manufacturer of contact lenses under that agreement or whether it acted merely as contract manufacturer.

B&L (U.S) supported the transfer price of the contact lenses purchased from B&L Ireland on the comparable uncontrolled price method using the market price of comparable lenses sold by other unrelated companies. B&L (U.S) introduced two expert witnesses to support the rate charged to B&L Ireland as being at arm's length. The evidence by the two experts suggested that the 5% royalty was consistent with rates charged in licensing agreements for similar technology in the contact lens industry.

Transfer price of contact lenses

The court accepted the method adopted by B&L (U.S) i.e. the comparable uncontrolled price method. But, the court found that the data were not sufficiently comparable in their unadjusted state, given that additional duty and freight costs were incurred by B&L (U.S) but were not incurred by the purchasers in the comparable transactions. After adjusting for this difference, the court found that the transfer price charged to B&L (U.S) was still at or below prices that would have been charged for similar lenses by a third party manufacturer.

Royalty

In respect of royalty the court applied its own approach of discounted future earnings analysis to determine that the arm's length rate of royalty for the agreement was 20% of net sales.

12. Onus of Proof

The onus of proof is upon the taxpayer in Malaysia. New Zealand seems to place the burden on the Commissioners of Inland Revenue. Since the onus is on the taxpayer, it is up to him to give evidence in support of his claims –

i. by expert witnesses,

ii. data of comparable uncontrolled prices between independent parties, and

iii. industry practice.

13. Transfer pricing may be complex; the complexity may be a challenge to Revenue Authorities in developing nations. But many multinational enterprises are now learning that Malaysia has the expertise to unveil transfer pricing mechanisms. The game better be over.

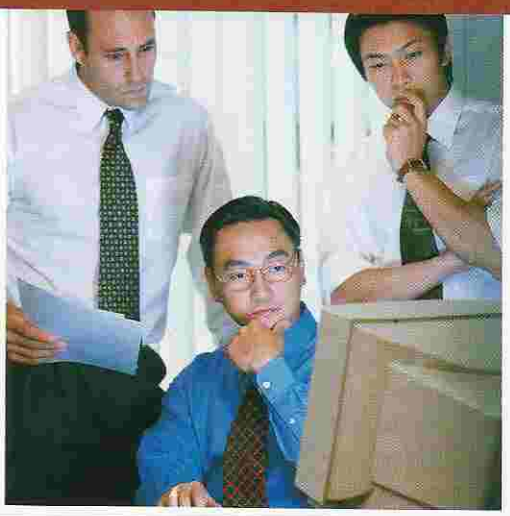
The Author

Dr. Arjunan Subramaniam

is an advocate and 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 Arjunan on Malaysian Revenue Laws, 8 volumes, Sweet & Maxwell Asia, comprising direct and indirect taxes.

Understanding Stock Options

- A Malaysian Perspective



By KAREN TAN AND LIM TIEN SIM

The concept of employee stock ownership plan ("ESOP") was developed in the 1950s by Louis Kelso, a lawyer and investment banker, who argued that the capitalist system would be stronger if all workers, not just a few stockholders, could share in owning capital-producing assets. Although ESOPs were introduced and encouraged in the earlier years, the number of ESOPs only rose dramatically in the US much later when a statutory framework for ESOPs was implemented. There are now approximately 11,000 ESOPs, introduced in different forms covering over 8.5 million employees in the US.

ESOPs can be introduced in a variety of ways. Some plans are introduced as stock options whilst others are structured as stock awards or stock purchase plans. The most common form of ESOP i.e. stock options is very popular and is widely used as an additional form of employee remuneration and reward scheme. In the recent years, many multinational companies offer stock or share options which are generally reputed to be useful in attracting and retaining the employees in a company and a good way of keeping employees loyal to the company.

Employee Stock Option Scheme

An employee stock option scheme ("ESOS") refers to schemes where employees are granted with options to acquire the shares of its employer or a foreign holding company at a discounted price in a future date. In an ESOS, employees can buy stocks of their company directly at a discount, or where the stocks are given as a bonus.

Although ESOS are offered in many different forms, the schemes will generally have the following key features:

i) Offer to join the ESOS
Employees are provided with the offer to join an ESOS under which they will be granted with a prescribed amount of options, usually based on their seniority and level of remuneration. The options are generally provided in several stated periods over a fixed duration. For example, the ESOS may provide that the options will be granted in equal portions each quarter over a period of a year.

ii) Conditions of grant
The options are usually granted subject to the condition that the employee remain an employee of the local subsidiary at the time the options are granted.

iii) Exercise of options within a prescribed period
The employees are usually required to exercise their options and acquire the shares of the company within a prescribed period (e.g. of one month) from the date the options are granted, after which the options will lapse.

iv) Exercise price
The options entitle the employees to acquire the shares of the company at a discounted price ("**Exercise Price**").

The amount of the discount is usually calculated using a formula prescribed in the ESOS. For example, the ESOS may provide that the Exercise Price will be 80% of the market value of the shares at the date of grant.

The employees will be able to benefit by exercising the options and acquiring the shares if the prices of the shares appreciate in the future. However, if the shares of the company depreciates and are worth less than the Exercise Price in the future, the employees can opt not to exercise the share options as they will be able to acquire the shares at a lower price from the market.

To overcome the risk that share prices may drop, some ESOS provide for the Exercise Price to be calculated based on the lower of a percentage of the market value of the shares at the date of grant or the date of exercise of the options, whichever is the lower.

In implementing an ESOS, there are various statutory and regulatory compliance issues. In addition, there are also tax issues under an ESOS. For instance, some countries tax stock options when they are granted while others tax them when they are exercised and/or sold. Our discussion focuses on employee stock option schemes and the tax issues arising under such schemes, from the Malaysian perspective.

Taxation of ESOS

The Malaysian Income Tax Act ("ITA") does not contain any provision dealing specifically with the taxation of benefits or perquisites arising from share option schemes for employees. In the absence of any specific provision in the ITA and any Malaysian case law on point, the timing of when such benefits are taxable depends on cases decided overseas, particularly those in the United Kingdom.

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The principles established in the United Kingdom case of *Abbott v. Philbin* (39 TC 82) is generally regarded as having persuasive force in Malaysia. The *Abbott* case is often cited in Malaysia for the proposition that stock options granted to employees are taxable on the date of grant, and this is the view held by the tax authorities. The *Abbott* case considers the taxation of options which are immediately exercisable and the reasoning of the case may support the argument that options that are not immediately exercisable when granted should not be taxed until they become exercisable.

However, the Director-General of Inland Revenue Board ("IRB") has taken the position that the gains derived from the exercise of share options by employees are a perquisite in respect of having or exercising employment and therefore, constitute employment income under sec. 13(1)(a) of the ITA.

As such, employees are generally subject to tax on the spread between the fair market value of the underlying shares at the time the option is granted and the option exercise price of the shares. In other words, the taxable event arises on the date of grant of share options. The taxable benefit is also ascertained at the date of grant by deducting the Exercise Price of the shares from the fair market value:

Taxable Benefit = Fair Market Value – Exercise Price

The IRB has the discretion to ascertain the market value of the shares. For listed companies, the fair market value of the shares is generally calculated based on the average of the highest and lowest price for the shares on the date of grant. For non-listed companies, the market value is determined based on a comparison between the net tangible assets against the number of ordinary share of the company as stated in the balance sheet on the date of grant of the option, calculated in the following manner:

$$\frac{\text{Net Tangible Asset}}{\text{Number of Ordinary Share}} = \text{Market Value}$$

The IRB also requires the company to compute the NTA value and the balance sheet as at the date of grant of the option duly certified by external auditors.

Whilst the taxable event occurs on the date of grant, the employees will only be required to pay taxes upon exercising the share options. The benefit derived from the share options will not be taxed separately but will form part of the employment income. Resident individuals are taxed on a scale of 0% to 28% whilst non-residents will be taxed at the flat rate of 28%.

Notification requirements

In Malaysia, the grant of an ESOS will be subject to various regulatory notification requirements, including (but not limited to) the following:

i. **IRB notification**
The employer is required to notify the IRB of the grant of ESOS. Before the IRB prescribed form was introduced, notification was made in a letter format. However, since the issuance of the prescribed IRB form in 2000, employers are required to report the benefits in a prescribed form within 30 days from the date of grant.

Upon the IRB's review of the form, the IRB will revert to the company with its computation of the taxable benefits (if any) arising from the ESOS. The IRB will also set out the manner in which the employer should withhold tax on the taxable benefits (if any) under the Schedular Tax Deduction ("STD") scheme. It may be possible, in some circumstances, for companies to request for special concessions from the STD scheme.

ii. **Exchange control notification**
The employer or employee is required to comply with exchange control notifications where the shares offered under the ESOS are the shares of a foreign company and the amount to be remitted by the employees under the ESOS exceeds RM10,000 per employee on a cumulative basis.

iii. **Securities Commission notification**
Where the ESOS constitutes the making available of, offering for subscription or purchase of, or making an invitation to subscribe for or purchase, securities of a corporation incorporated outside Malaysia pursuant to an ESOS, the company offering the ESOS is also required to submit an information memorandum to the Securities Commission on the details of the ESOS.

In certain instances, if the ESOS is not purely an employee share or employee share option scheme, the company may be required to obtain the Securities Commission's prior approval for the ESOS.

Conclusion

Apart from ESOS, there are various other stock ownership plans with different characteristics incorporated in the scheme. Some of them include stock awards i.e. where employees may exercise their options and acquire the shares for free (without having to pay an Exercise Price), restricted stock units and stock purchase plans.

Depending on the manner and structure of the stock ownership plans, there may be different tax implications under each scheme. As such, it is important to ensure that each ESOP is reviewed and considered on its own structure in determining the regulatory and tax implications arising under the respective scheme. It is noteworthy that the notification and approval requirements in Malaysia pertaining to ESOPs have been significantly relaxed over the recent years, making compliance to the existing framework much easier.

Often, companies have overlooked the importance of the tax filings and compliance matters pertaining to ESOPs and many companies are, in fact, not cognisance of the filing requirements with the IRB. In line with the increasing number of audits and investigations conducted by the IRB in the recent months, it would clearly be in the interest of companies to ensure compliance or be prepared to face the penalties.

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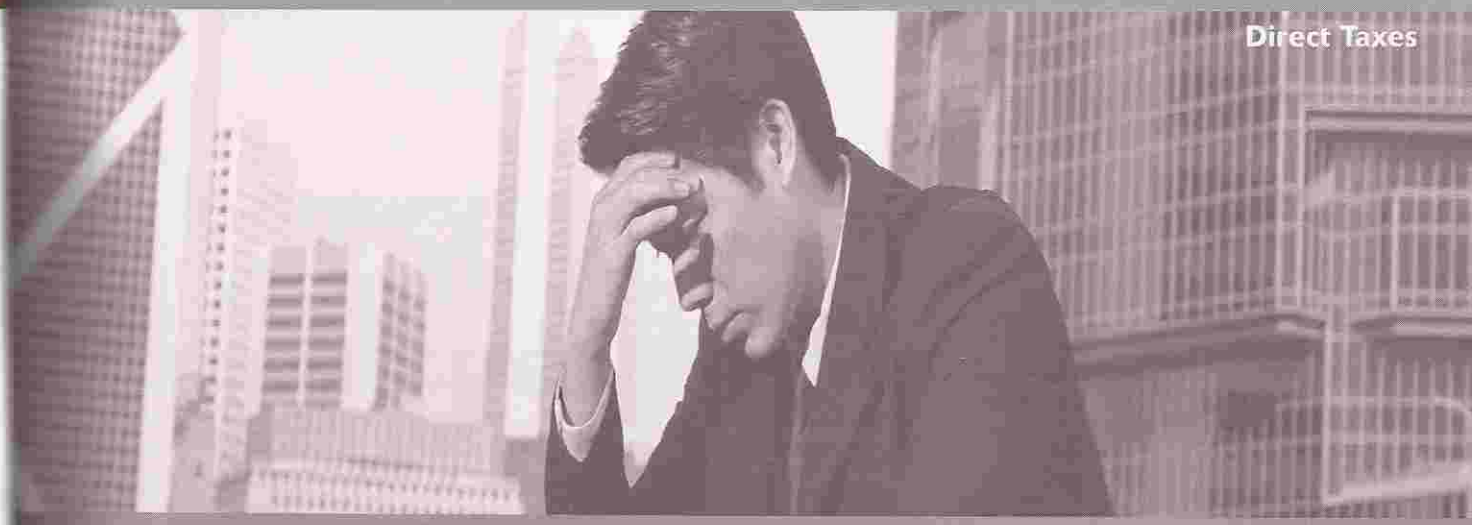

Enforcing Tax Compliance

– Relevant Issues For Criminal Prosecution

By **DR SIVAMOORTHY SHANMUGAM**

Relevant Provision under the Income Tax Act 1967 relating to Criminal Prosecution

The Inland Revenue Board has recently announced that where serious fraud has been committed, criminal proceedings may be undertaken to act as deterrence for taxpayers to evade tax and breach of trust under the Self Assessment System. In other words, the Inland Revenue Board wants a "pound of flesh" instead of a monetary settlement.

The offence or misdemeanor of perjury is committed when a person knowingly and wilfuly makes a false statement particularly in a statutory declaration e.g. income tax returns etc. Culpable omissions happens when items are deliberately omitted from declaration and this can constitute to negligence, fraud or wilful default.

Basically criminal prosecutions cover two categories of criminal offences, namely:

- Tax evasion
- Non-compliance with tax legislation

Tax evasion offences (wilful evasion) is governed by sec. 114 of the *Income Tax Act 1967*. Section 114 of the *Income Tax Act 1967*, states that any person who wilfuly and with intent evades or assists any person to evade tax by:

- Omitting any income from a return;
- Making a false statement or entry in a return;
- Giving a false answer (orally or in writing) to a question asked or request for information;
- Preparing / maintaining / authorising the preparation or maintenance of false books or account or other false records;
- Falsifying / authorising the falsification of books of account or other records; and
- Making / authorising the use of fraud, art or contrivance.

Besides sec. 114, criminal prosecution can be instituted on other non-compliance issues as follows:

Sec 112 (1) - Failure to furnish return or give notice of chargeability

Sec 113 (1) - Make incorrect returns or gives incorrect information

Sec 115 - Leaving Malaysia without payment for tax

Sec 116 - Obstruction of officers in the course of their duties

Sec 119A - Failure to keep records

Sec 120 - Other offences

Potential Prosecution Cases

Cases are more likely to be referred for prosecution if they involve the fabrication of false documentation or a conspiracy to defraud the Revenue, regardless of the amounts involved provided that the evidence to mount such prosecution is still available.

Normally, the Revenue will focus on tax fraud which is generally defined as deception and misrepresentation of material facts.

Tax fraud usually involves false documentation, returns or statements and includes attempted evasion, conspiracy to defraud, aiding, abetting or counselling(?) fraud and wilful failure to file returns.

Therefore in all tax fraud cases, one could identify the presence of these common elements:

- An understatement of tax liability
- Wilful intent to evade taxes
- Course of action demonstrating the taxpayer's intent.

The mere existence of an understatement of tax liability is not indicative of wilful intent to evade taxes. Wilful intent is usually shown by a pattern of understatement, deceit, concealment, misleading acts or misrepresentation.

Since the burden of proof in any fraud case rests with the Revenue, it must be concerned with these acts in order to establish any alleged fraud.

In the case of *Public Prosecutor v. Lee Siew Ngok (1966) 1 MLJ 225*, *Maclyntyre J.* said :

> *"Awareness is an essential ingredient of the charge for if he was not aware of the omission, the question if wilful making a false certificate of disclosure will not arise"*

In the United Kingdom, case of *Regina v. Hudson, 1956, 36 T.C. 561*, the appellant was convicted of making false statement to the prejudice of the Crown and the public revenue, with the intent to defraud in that he had sent to the Inland Revenue (i) accounts which falsely stated the profits of the business and (ii) a certificate of disclosure which he know to be false. On appeal against conviction, the appellant contended that the offences with which he was charged were unknown to the common law and were not indictable. It was held that he had been rightly convicted since the offences charged disclosed the offences of fraud on the Crown and the public which were indictable as a common law misdemeanor.

The onus of establishing "fraud or wilful default" is on the Inland Revenue Department. In the United Kingdom case of *Hillenbrand v. CIT*, the Lord President said:

> *"It was contended to us on behalf of Crown that wilful default within the meaning of the Income Tax Acts can be established by the Inland Revenue by means of a presumption of guilt without the Inland Revenue requiring establish wilful default on the taxpayer's part. I should like to make it perfectly clear that in my view there is no warrant whatever for the idea that under the Income Tax Acts people are presumed to be guilty of wilful default within the meaning of those words in sec. 47 of the Income Tax Act of 1952. The onus is quite clearly upon the Crown, and the taxpayer is not in the position of having to prove himself innocent of such a charge without proof by the Inland Revenue that he is guilty of default ".*

Common Fraudulent Schemes

Amongst the various fraudulent practices undertaken by taxpayers, the following are common indicators which constitute sufficient evidence to consider a referral for criminal prosecution.

Unreported Income

Perhaps the most direct means of reducing income for tax purposes is merely not to record receipts as income. Some common examples are as follows:

- Customers cheques endorsed directly to third parties for the purchase of stock, real estate or personal expenses.
- Suppressed corporate receipts deposited in concealed bank accounts.
- Cheques payable to business for volume discounts, incentives and insurance rebates are frequently misappropriated.

Shifting of Income Among Entities

Shifting of income among various entities, domestic and foreign has a widespread scheme or technique for both tax avoidance and tax evasion. While many inter-company transactions are perfectly legitimate, there are frequent attempts to move income improperly to obtain least tax impact.

Methods utilised include the use of sham corporations which exist only on paper, the use of unrealistic sales or purchase prices between a domestic company and its foreign affiliates, and the failure to properly allocate various expenses to affiliates. Shifting of income solely between domestic corporations is also common, especially when one entity is in a loss position; and consolidated returns are not being filed.

Even when the transactions are not at arms length between controlled entities, the allegations of fraud is difficult to sustain when the facts of the transactions are disclosed in records and returns. Sometimes, however such shifting is accomplished by fictitious entries, false invoices, etc and allegations of fraud are more likely to be sustained.

False and Improper Deductions

In some cases the taxpayer may deduct items that are completely fictitious namely:

- Fictitious subcontract wages.
- Fictitious purchases using "shell" companies as a conduit to divert corporate funds.
- Fictitious commissions.

Fraudulent Stock Manipulation

The most direct means of reducing the gross profit of the business is by complete omission of closing stock figures.

Section 35(3) provides that the value of any particular item of stock at the end of the period shall be taken to be:

i) An amount equal to its market value at the time; or

ii) If the person so elects and that item is physically tangible, an amount equal to the cost of acquiring the stock

The taxpayers method of valuing trading stock must generally conform to acceptable accounting practice and must be consistent every year. The Revenue scrutinizes withdrawal of stocks for private use and any change in method of valuation.

Diversion of Business Assets for Personal Benefit

Some common examples are as follows:

- Use of business or company vehicles for private use and accordingly charging fuel and maintenance expenses to the company account.
- Occasionally, furnitures and electrical equipments purchased by the company were used solely for the directors private household.

Kickbacks and Payoffs

Kickbacks and payoffs are generally defined as payment in cash, goods, or services to agents and /or employees or to others for some kind of preferential treatment. The practice of making kickbacks and payoff payments appears in nearly every segment of business, large and small. Such payments are difficult to trace through records because they may be hidden in a maze of bookkeeping entries and buried in any number of accounts such as cost of sales, sales returns, advertising, repairs, miscellaneous or practically any other account. Once such a payment has been uncovered, there is the further problem of determining who received the payment. The payor often refuses to identify the payee.

In dealing with kickbacks and payoffs that are discovered, it is generally agreed that:

i. Kickbacks and payoffs are always taxable on the recipient.

ii. If the recipient is not disclosed, no deduction will be allowed to the payor.

iii. Kickbacks and payoffs are not deductible unless they are both ordinary and necessary business expenses.

iv. Kickbacks and payoffs are deductible even if they are in violation of any Federal, State or local statute, ordinance or regulations (contrary to public policy).

Criminal Prosecution

Among the measures taken by the Inland Revenue Board to deter tax fraud is to set up special investigation division which specialises in criminal investigation to effectively carry out enforcement against tax evaders. By practising effective enforcement, the Revenue will gain the respect of confidence from the good taxpayer and the public at large.

The Inland Revenue Board uses certain guidelines and criteria in deciding whether a case should be subjected to criminal investigations. The criteria are as follows:

- The nature and method used to commit the offence.
- Whether the offender has previous negative records with the Inland Revenue Board
- Compliance with tax laws
- Any previous conviction
- Nature of the crime, the frequency and notoriety of the crime

In countries like Canada, the criminal investigation and prosecution involves not only tax evasion but also fraudulent refunds and credits. Its special enforcement programme targets those taxpayers who derive income from illegal activities. It is primarily intended to minimize accumulation of illicit wealth and cause disruption to organized crimes. In Canada, the criminal division scrutinizes approximately 500 referrals to criminal investigation annually.

Basically criminal investigations should encompass the following objectives.

- To provide maximum deterrence to non-compliance of tax laws by investigation, penalising and publicising cases of wilful and deliberate evasion. This publicity contributes to public trust, fairness and integrity of self assessment.
- To cover a wide range of economic sectors, geography and income ranges. The programme should cover sectors involved in underground economic activities such as gaming, betting sectors, illicit drugs, entertainment and prostitution and under table payment in construction / development sector.

Criminal investigation is a program that when properly administered, enhances public confidence in a self assessment tax system and is an integral component of strategies to address non-compliance with tax laws.

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Estimating The Extent Of Income Tax Non-Compliance In Malaysia And Australia Using The Gap Approach (Part II)

By DR MOHANI ABDUL AND PROF. PETER SHEEHAN

In the first part of this article, we looked at the extent of non-compliance in Malaysia and Australia. The second part discusses two potential reasons of coverage and non-compliance for the low ratio of actual to derived taxable income.

1. Interpreting the Taxable Income Gap

1.1 Interpreting the taxable income gap

The estimates provided above imply that only about 52% of derived taxable income in Malaysia is in fact subject to tax, by comparison with about 95% for Australia. This in turn means that a very substantial part of Malaysia's potential taxing capacity is unutilised, by comparison with the position in Australia, and hence that, for a given level of government expenditure, tax rates on income currently subject to tax are higher than might otherwise be the case.

There are two potential reasons for a low ratio of actual to derived taxable income. One is ***coverage or scope***: the possibility that the coverage or scope of the taxation law is limited, so that a significant proportion of derived taxable income is not legally liable for tax. The other is ***non-compliance***: the possibility that a significant proportion of derived taxable income, while legally liable for tax, is subject to non-compliance and does not in fact lead to tax being paid. It is important to form some view on the extent to which coverage rather than non-compliance provides an explanation for the very high level of the taxable income gap in Malaysia. Thus, we investigate the issue of coverage in the next two sections. The discussion must inevitably be brief, and coverage is a topic that could be the subject of a full additional study.

1.2 Scope of personal income taxation

The available evidence suggests that, relative to developed countries such as Australia, the scope of personal income taxation in Malaysia is quite low. This is, of course, to be expected in a developing country, where corporate income taxes tend to be more important than taxes on personal incomes, while the reverse is true in developed economies (Burgess and Stern, 1993). We do not here examine the coverage of personal income tax in Malaysia relative to that in other developing countries.

One simple indicator of the scope of the personal income tax system is the ratio of the number of taxable individuals to the number of employed persons. This indicator should, of course, be treated with care, for many factors other than the level of employment affect the number of individuals paying tax. Thus in Australia, for example, many individuals not working but living on retirement income or income from assets are subject to tax. It should also be remembered that coverage in terms of individuals is very different to coverage in terms of income, for if many persons on low incomes are not required to pay tax the aggregate income foregone may be modest. In addition, in Malaysia it is possible for a married couple to elect to be taxed as a household (combined assessment), while this is not possible in Australia. Nevertheless, the figures shown in Table 1 are striking. For the three years under study, the average ratio of the number of taxable individuals to the number of persons employed was 17.5% in Malaysia and 97.6% in Australia. By this measure, the coverage of personal income tax is much lower in Malaysia than in Australia.

Table 1: Ratio of taxable individuals for Malaysia and Australia for the three years under study

Country	Malaysia			Autralia		
Year	1995	1996	1997	1995	1996	1997
No. of employed individuals ('000s)	7,645	8,400	8,569	8,218	8,320	8,316
No. of taxable individuals ('000s)	1,547	1,275	1,459	7,861	8,200	8,200
Ratio (%)	20.2	15.2	17.0	95.7	98.6	98.6

Source: Malaysia: *Taxation Statistics*, various years and International labour Office 1998, p. 108; Australia: ATO, *Taxation Statistics*, various years and ABS Labour Statistics (August data) for various years.

In large part, this low coverage in Malaysia can be explained by the structure of the income tax system, relative to the structure of the incomes of Malaysian households. In 1995 the average household income in Malaysia was RM24,084 (Department of Statistics, 1997) and it is likely that, as is common with most national income distributions, the median income was significantly below the mean. Thus we can conclude that in 1995 considerably more than 50% of Malaysian households had incomes of less than RM24,000.

Table 2: Selected personal income tax deductions allowable, Malaysia, 1998

Type of deductions	Amount Allowed (RM)
1. Self and Dependent	5,000
2. Disabled Individual	5,000
3. Disabled Wife	2,500
4. Fees for education in scientific technology or vocational (Max)	2,000
5. Medical expenses for parents (Max)	5,000
6. Medical expenses on serious diseases individual, spouse and children (Max)	5,000
7. Purchase of basic supporting equipment for disabled person (Max)	5,000
8. Wife/Wives	3,000
9. Child relief @ RM800	(No limit to the number of children).

Source: IRB 1998a, p. 183.and *Income Tax Act, 1967*

Table 3: Example of a tax computation for household with combined assessment in Malaysia for year 1997

			RM
Total income			20,000
Less: Deductions			
Personal		5,000	
Medical expenses for parents		950	
Wife		3,000	
Children (RM800 x 4)		3,200	
E.P.F. and Insurance Premium		3,700	
Total Deductions			15,850
Chargeable Income			4,150
Tax on first RM2,500			0
Tax on RM 1,650 @ 2%			33
Income Tax Chargeable			33
Less: Rebates			
Self	110.00		
Wife	60.00		(Restricted to 33)
Total Tax Payable			Nil

Source: Inland Revenue Board of Malaysia 1998a, pp. 152-3.

The Malaysian income tax system includes a relatively generous set of deductions (or 'reliefs'), a tax free threshold of RM2,500 and a number of rebates. Some of the available deductions are shown in Table 2. If we assume that median household income in Malaysia in 1995 was RM20,000, then deductions for the husband, wife and (say) three children alone would amount to RM10,400, or 51% of median income. Taken together with the RM2,500 threshold, 63.5% of median income is already not subject to tax. In many cases, the availability of further deductions may mean that no income is subject to tax.

In a hypothetical example of the tax position of a family whereby the husband is an employee and receives a salary of RM18,000 per annum, while paying RM 3,500 to the Employees' Provident Fund (EPF) and insurance. His wife is a housewife but she receives rental income of RM2,000 from a house (given to her by her father). They have four children, all below 18 years of age, and claim RM950 for medical expenses for the husband's parents. The wife elects for combined assessment. The broad outline of the resulting tax assessment is shown in Table 3. The key point is that this family, with an income of RM20,000, close to the median household income in 1997, is not subject to tax, after consideration of deductions, the tax free threshold and rebates.

In addition to these deductions and rebates against personal income, the Malaysian income tax system provides for a range of exemptions on various types of personal income from tax which are more generous than those in Australia. Section 127 of the *Malaysian Income Tax Act* empowers the Minister of Finance to declare exemptions from income tax and states that the income specified in sch. 6 shall be exempt from tax. Some of these exemptions include:

- Donations received by approved charitable institutions.
- Pensions upon retiring from employment.
- Compensation for loss of employment and restrictive covenants.
- Certain types of interest income, such as that on government bonds and savings certificates.
- Income of an approved pension/provident fund.
- Scholarships.
- Retirement gratuities.

Capital gains (except for gains on the disposal of real property) are also exempt from tax in Malaysia, as noted above. Real Property Gains Tax is charged on gains arising from the disposal of real property situated in Malaysia or of interest, options or other rights in or over such land as well as on the disposal of certain categories of shares. However, as noted earlier in the article,

income from capital gains is not captured in the measure of derived taxable income estimated from national accounts data.

1.3 Scope of company taxation

As a developing country, Malaysia provides several tax incentives, both direct and indirect, such as in the manufacturing, agriculture and tourism sectors. These are provided primarily under the *Promotion of Investments Act 1986*, *Income Tax Act 1967*, *Customs Act 1967*, *Sales Tax Act 1972* and *Excise Act 1976*. In a range of respects, they are more generous than those in Australia. Many of these also have the effect of exempting income from tax, and hence reducing reported taxable income, rather than lowering the rate of tax.

The direct incentives are designed to grant partial or total relief from the payment of corporate income tax for a limited period of time, while the indirect incentives are given in the form of exemptions from import duty, sales tax and excise duty. Some of the direct incentives provided by the Malaysian Government are discussed below (Malaysian Industrial Development Authority [MIDA], 1999, pp. 1- 22).

1.3.1 Incentives for the manufacturing sector

The major incentives for companies in the manufacturing sector are the Pioneer Status and Investment Tax Allowance (ITA) and Reinvestment Allowance (RA). Eligibility for either Pioneer Status or Investment Tax Allowance is determined according to priorities, termed as 'promoted activities' or 'promoted products', as determined by the Minister of International Trade and Industry.

A company granted ***Pioneer Status*** enjoys partial exemption from the payment of income tax. It will only have to pay tax on 30% of its statutory income. The period of tax exemption is five years, commencing from the Production Day as determined by the Minister of International Trade and Industry. There is also an added incentive for companies that are located in the States of Sabah, Sarawak, the Federal Teritory of Labuan,[4] and the designated "Eastern Corridor" of Peninsular Malaysia (covers Kelantan, Terengganu, Pahang and the district of Mersing in Johor), whereby they have to pay tax only on 15% of their statutory income during the tax exemption period of five years.

A company granted an *Investment Tax Allowance* (ITA) is given an allowance of 60% in respect of qualifying capital expenditure incurred within five years from the date on which the first qualifying capital expenditure is incurred. The allowance can be utilised to offset against 70 % of the statutory income in the year of assessment. Any unutilised allowance can be carried forward to subsequent years until the whole amount has been used up. The balance of 30% of the statutory income will be taxed at the prevailing company tax rate. As with Pioneer Status, there is also an added incentive for companies located in the States of Sabah, Sarawak, the Federal Territory of Labuan[4] and the "Eastern Corridor" of Peninsular Malaysia. They are granted an allowance of 80% in respect of the qualifying capital expenditure incurred. The allowance can be utilised to offset against 85% of the statutory income in the year of assessment.

A *Reinvestment Allowance* (RA) is granted to manufacturing companies which have been in operation for at least 12 months and incur qualifying capital expenditure for the expansion of production capacity, modernisation and upgrading of production facilities, and diversification into related products and automation of production facilities. The RA is in the form of an allowance of 60% of capital expenditure incurred by the companies. The allowance can be utilised to offset against 70% of the statutory income in the year of assessment. Any unabsorbed allowance is allowed to be carried forward to the following years until it is fully utilised. A RA will be given for a period of fifteen (15) consecutive years of assessment beginning from the year the first reinvestment is claimed. The RA can only be claimed on completion of the qualifying project i.e. after the building is completed or when the plant/machinery is put to operational use. However, assets acquired for the reinvestment cannot be disposed within two years of reinvestment (can be disposed but the RA will be withdrawn).

1.3.2. Incentives for high technology companies

High technology companies are defined as companies engaged in promoted activities or in the production of promoted products in areas of new and emerging technologies. They must fulfil the following criteria:

Local research and development (R&D) expenditure to gross sales should be at least 1% on an annual basis. However, companies are allowed a period of three years from the date of operation/commencement of business to comply with this requirement. The percentage of science and technical graduates to total workforce should be at least 7%.

4 Only applicable to the hotel and tourist industry.

High technology companies are eligible for the following incentives:

1. Pioneer Status with full tax exemption at statutory income level for a period of five years; or
2. Investment Tax Allowance of 60% on qualifying capital expenditure incurred within a period of five years. The allowance can be offset against the statutory income for each assessment year without any restriction.

1.3.3 Incentives for strategic projects

Strategic projects are generally defined as projects involving products/activities of national importance. They usually involve heavy capital investments with long gestation periods; have high levels of technology and are integrated; generate extensive linkages and generally have significant impact on the economy. Such projects are eligible for the following incentives:

1. Pioneer Status with full tax exemption at statutory income level for a period of 10 years; or
2. Investment Tax Allowance of 100% on qualifying capital expenditure incurred within a period of five years. The allowance can be offset against the statutory income for each assessment year without any restriction.

1.3.4 Incentives for the agricultural sector

Under the *Promotion of Investments Act 1986*, the term "company" in relation to agriculture includes agro-based cooperative societies and associations, and sole proprietorships and partnerships engaged in agriculture. Companies producing promoted products or engaged in promoted activities are eligible to apply for Pioneer Status and for the Investment Tax Allowance.

In enabling agricultural projects to enjoy greater benefits, the Malaysian Government has broadened the definition of qualifying capital expenditure to include the following:

A. The clearing and preparation of land;

B. Planting of crops;

C. Provision of plant and machinery used in Malaysia for the purposes of crop cultivation, animal farming;

D. Aquaculture, inland or deep-sea fishing and other agricultural or pastoral pursuits;

E. Construction of access roads including bridges, the construction or purchase of buildings (including those provided for the welfare of persons or as living accommodation for persons) and structural improvements on land or other structures which are used for the purposes of crop cultivation, animal farming, aquaculture, inland fishing and other agricultural or pastoral pursuits. Such roads, bridges, buildings, structural improvements on land and other structures should be on land forming part of the land used for the purpose of such crop cultivation, animal farming, aquaculture, inland fishing and other agricultural or pastoral pursuits.

In view of the time lag between start-up of the agricultural project and processing of the produce, integrated agricultural projects are eligible for an ITA for an additional five years for expenditure incurred for processing or manufacturing operations.

1.4 Scope of the Malaysian income tax system

Thus, while this discussion of scope is far from complete, it is evident that the scope of the Malaysian income tax system is much lower than in Australia and other developed countries. In part, this difference is due to the current stage of development of the Malaysian economy, but it is also partly due to specific features of Malaysia's economic and fiscal strategy.

It is apparent from the figures on different types of taxable income analysed above (Table 10 of Part 1 of this article) that the IRB in Malaysia depends more on corporate income taxes than on individual income taxes, while the reverse is true for the ATO. Hence, this confirms the finding of Burgess and Stern (1993, pp. 762-830) that corporate income taxes are more important than taxes on the incomes of individuals in developing countries, while in developed countries, taxes on income of individuals are more important. They argued that the constraints on raising revenue through personal income taxation in developing countries are many, including problems of measurement, administrative capability, low literacy, and poor accounting. An economic structure dominated by agriculture and small-scale (often unregistered) enterprises makes personal income difficult to trace, and hence to tax such income (see Musgrave 1969; Goode 1984; Bird and Oldman 1990). As a result, revenue from this source in developing countries tends to accrue largely from taxes on the wages of employees in public-sector enterprises and foreign corporations to whom tax laws can be more easily applied. Collection from such a narrow base, often at high rates, creates resistance which is apparent in the experience of a number of countries (see Gillis 1989; Tanzi 1991). On the contrary, in industrialised countries, wage and salary employment is more widespread and the capability to tax earned incomes outside this net, for example those of self-employed persons is greater. This partly explains the greater importance of individual income taxation in revenue for developed or industrialised countries.

2. Conclusion

The central finding of this article is that the income tax gap in Malaysia, calculated in terms of a methodology validated by its application to Australian and US data, amounted to about 48% of derived taxable income. That is, only about 52% of derived taxable income, estimated primarily from national accounting sources, is captured in reported taxable income in Malaysia. This is very much lower than the comparable figures of about 95% for total income tax in Australia and of about 88% for personal income in the U.S. Indeed, it is so low that it must be regarded as highly likely that both of the possible explanations – low scope and a high level of non-compliance – are significant contributing factors to the outcome.

While some aspects of the low scope of the Malaysian income tax system, relative to that in Australia and other similar countries, have been documented in this article, it has not been possible to quantify the relative contributions of low scope and high non-compliance to the explanation of the central finding of this article. Thus the finding that only 52% of derived taxable income in Malaysia is subject to tax provides a strong indicator of a substantial level of income tax non-compliance, but does not lead to a quantitative estimate of this level.

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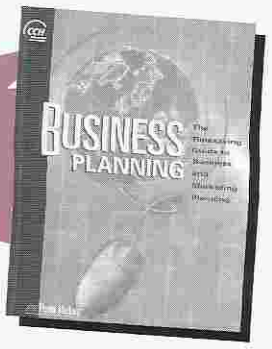

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Malaysia – Economic Recovery

By DR. A. THILLAISUNDARAM

Miracle Economy

Malaysia prior to 1997 was labelled a "miracle economy' along with other Asian countries such as South Korea, Thailand and Indonesia. This was because it had a long and sustained period of economic growth from 1976 to 1996 with only a few interruptions. This growth saw the country changing from being an essentially agricultural country to being an industrial one with manufacturing forming a large part of its activities. The emphasis was on exports and thus electronic components manufacture and other manufactured goods became the mainstay of the economy. During the early 1990s exports grew at double digit rates and averaged over 20% per annum.

The Asian Financial Crisis

The financial crisis of 1997 changed all these. The crisis caused undue problems to the business sector and to the people in general. The value of the Malaysian Ringgit fell drastically, the Stock Exchange values were similarly affected and banks and other financial institutions faced difficulties due to the sudden rise in non performing loans and falls in value of the collaterals pledged. At the height of the crisis the Malaysian Ringgit's value had dropped to as low as RM4.88 to the US dollar. The Kuala Lumpur Stock Exchange values had also similarly declined. For instance, the Kuala Lumpur Composite Index (KLCI), a barometer of stock values was at over 1,250 mark in early 1997 but declined to less than 600 mark by the end of that year. By around August of the following year it had further declined to around 300 mark due to various developments. These were the low points in the history of the economy whose Gross Domestic Product (GDP) had been growing at a rate of about 10% prior to the crisis. During the crisis period, the growth rate had dropped to a negative 7.36%. Since then it has recovered to the positive territory but not as high as before.

The Government's Efforts

The government took necessary measures to arrest the decline and bring back growth. Some of the steps taken since the crisis are the introduction of selective capital controls, pegging of the Malaysian Ringgit at RM3.80 to the US Dollar and recapitalisation of the banking system which was heavily weighed down by the non performing loans. The restructuring of the banking system has been effected to reduce the burden of non performing loans. This was done through special purpose vehicles such as the asset management company (Danaharta) and the recapitalisation company (Danamodal). Through the efforts of these organisations the non performing loan issue has declined in importance in the banking system. The financial institutions have now become bigger and stronger through government initiated mergers.

Economic Stimulation

The government has been stimulating the economy ever since the Asian financial crisis-and has run deficit budgets seven years in a row. The budgets have been purposely kept in deficit to help stimulate economic growth through greater public expenditure and tax reductions and incentives to encourage domestic consumption growth and private sector investment. The public expenditure and tax incentives in these budgets have basically been pump priming actions to get the economy moving forward at a greater speed. In May 2003, as a consequence of the Severe Acute Respiratory Syndrome (SARS) scare in the Asian region and the fall out from that, the government introduced another stimulus package to halt the decline in growth which was expected from the fear of the spread of that deadly disease.

Capital Market Woes

The Kuala Lumpur Stock Exchange has gradually seen improvement in trading since its lows in 1998. The Kuala Lumpur Composite Index has recovered from the below 300 mark to stand at over 730 in August 2003 (see figure 2 for the trend). At the end of January 2004, it had surpassed the 800 mark. This is not, however, considered a spectacular improvement as more than five years have passed since the onset of the crisis. Other bourses in the region have improved substantially. The SARS scare had an adverse impact on the local and regional capital markets in the

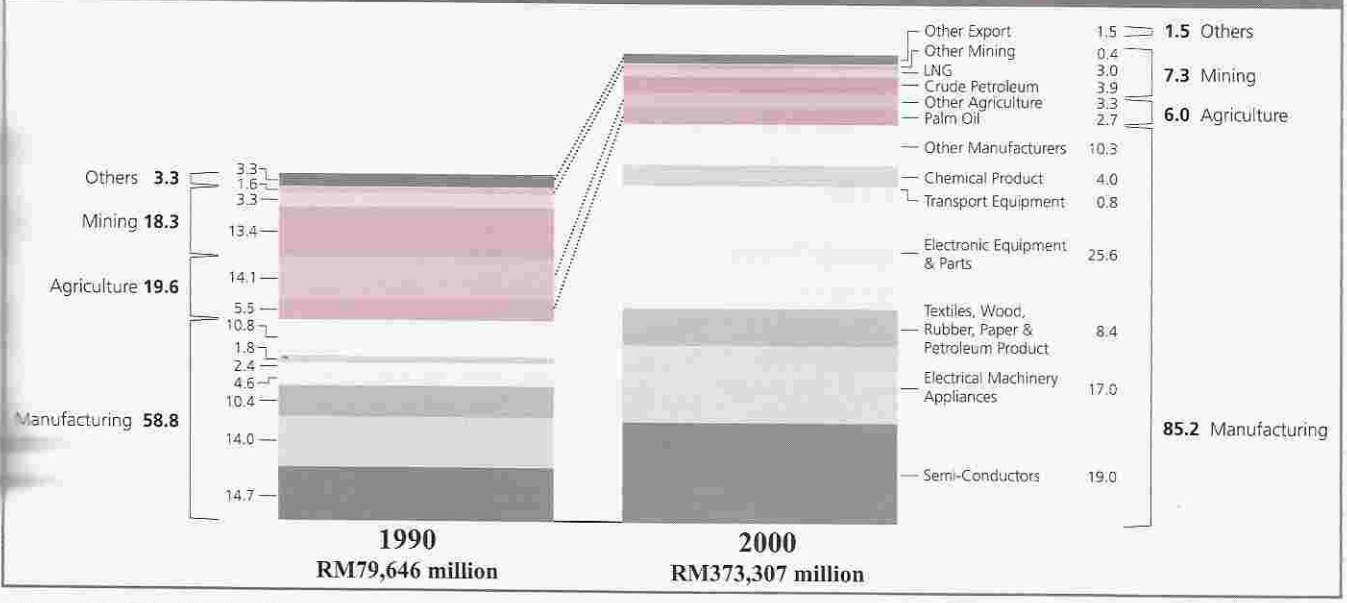
first half of 2003 but the fear of the disease has receded and stock prices are gradually trending upwards again. However, the current poultry-related flu epidemic in the East and South-east Asian regions are having a dampening effect on the recovery.

Some academic economists in the country attribute the less than sterling performance of the capital market to measures taken at the height of the Asian financial crisis. The argument put forward is that the real sector of the economy has benefited by the measures taken but the financial markets have borne the burden for this. The real sector has recovered substantially since the crisis due to the Ringgit peg and capital controls and stimulus packages but not so much the financial sector. Trading volumes in the Stock Exchange has recovered but not to the extent where the industry players can achieve the type of returns of yore. The securities industry has had to undergo substantial changes in their fee structure and trading hours to achieve competitiveness and survival. Lack of adequate foreign participation in the Malaysian capital market may be a reason for the low volume but other explanations have also been put forward. One is that the low volatility due to low volumes can result in higher liquidity risk premiums and this could be a reason for the not so high share prices prevailing in the stock market.

Gross Domestic Product Growth

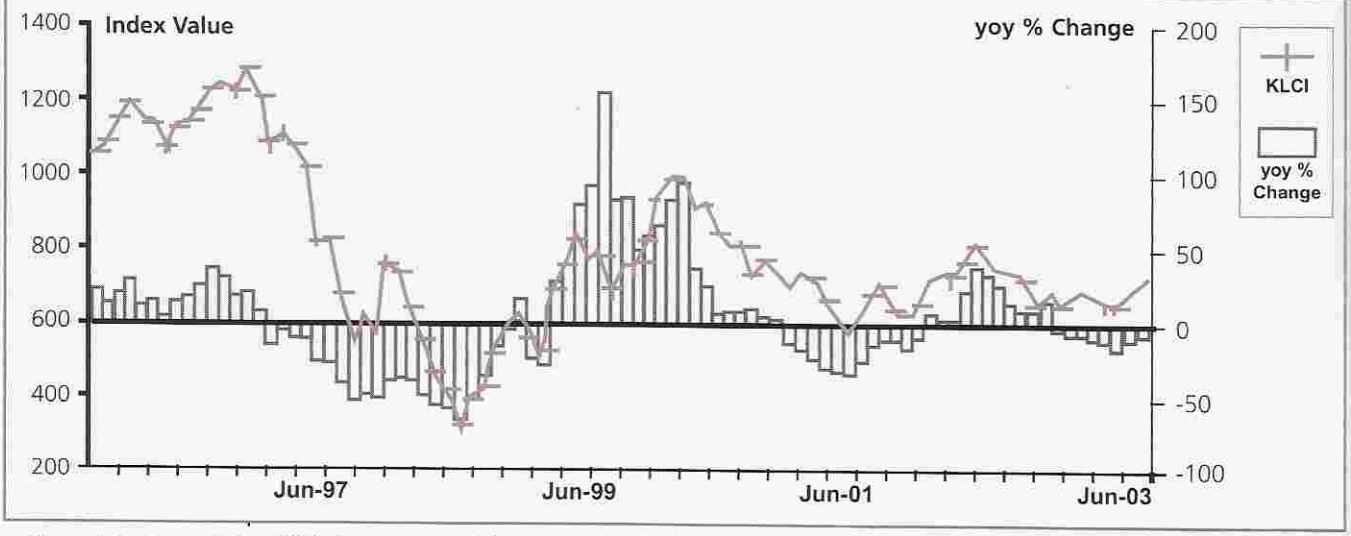
Malaysia's high rate of GDP growth turned negative in 1998 due to the financial crisis and its effect on the real economy. The many selective measures, deficit budgets and economic stimulus packages have turned round the economy to show a positive rate of growth. Only in 2001 due to the economic aftermath of the September 11 terrorist attacks in the USA did the growth rate reach near zero level. Figure 3 gives the trend in the growth rate of the real GDP since 1998. The GDP growth rate in 2002 was around 4.2 percent which was a great improvement against the 0.4 percent achieved in 2001. Much of this improved growth can be attributed to strong domestic demand and good export performance of the country's products. However, much of the improvement in the rate of growth was due to public expenditure rather than through private sector expenditure growth.

Figure 1: **Structure Of Export, 1990 & 2000 (%)**



Source: The Third Outline Perspective Plan 2001-2010, Percetakan Nasional Malaysia Berhad, 2001.

Figure 2: **KLCI Index and yoy Rate of Change**



Source: The Sentinel, June 2003, AmInvestment Management Sdn Bhd.

Asean Free Trade Area

The Asean Free Trade Area (AFTA) is of major significance in the economic liberalisation and integration of the Southeast Asian nations. Malaysia is part of this grouping and the aim is to bring down intra regional tariffs to between zero and five percent over a fifteen years period beginning 1993. The reduction of tariffs is expected to bring about greater competitiveness and attract more foreign direct investment into this region which over the last five years have declined substantially with the rise of China as an economic powerhouse.

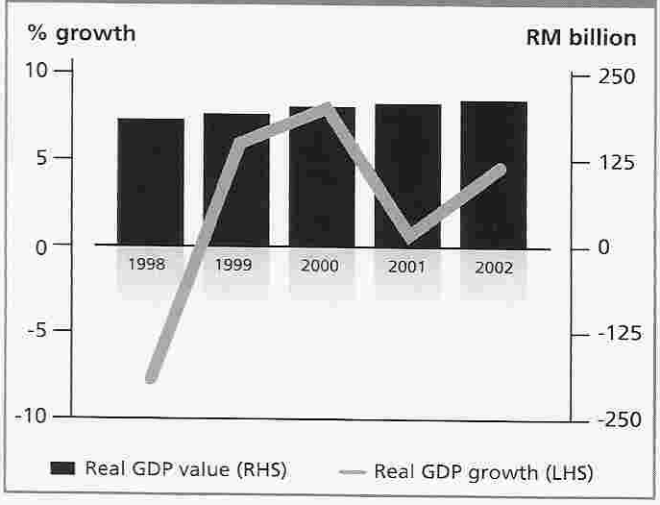
Foreign Direct Investment

Foreign direct investment (FDI) was substantial in this region until the run up to the crisis period. Malaysia was only second to Singapore in terms of attracting and receiving FDIs. Competition from China and other emerging countries especially from Latin America have eroded FDI flows to Malaysia. Prior to the crisis, investment from Japan was significantly more than the other countries but the situation now sees more investment from the USA and the European Union. FDI flows into Malaysia reached a peak of over RM7 billion in 1996 but by 2000 had declined to under RM4 billion. The Malaysian government is actively promoting Malaysia as an investment centre and it is hoped that FDI flows will return to old levels with greater liberalisation in the coming years.

Conclusion

The country is still going through various phases to enhance its competitiveness in a global environment. There have been stimulus packages and deficit budgets to move the economy forward. However, the September 11, 2001 events in the USA and the 2003 SARS scare nearly derailed some of these efforts. The economy's growth rate is again in positive territory and a return to pre-crisis period growth rates is hoped for in the coming years as the world economy moves forward again.

Figure 3: **Real GDP**



Source: Annual Report 2002, Bank Negara Malaysia

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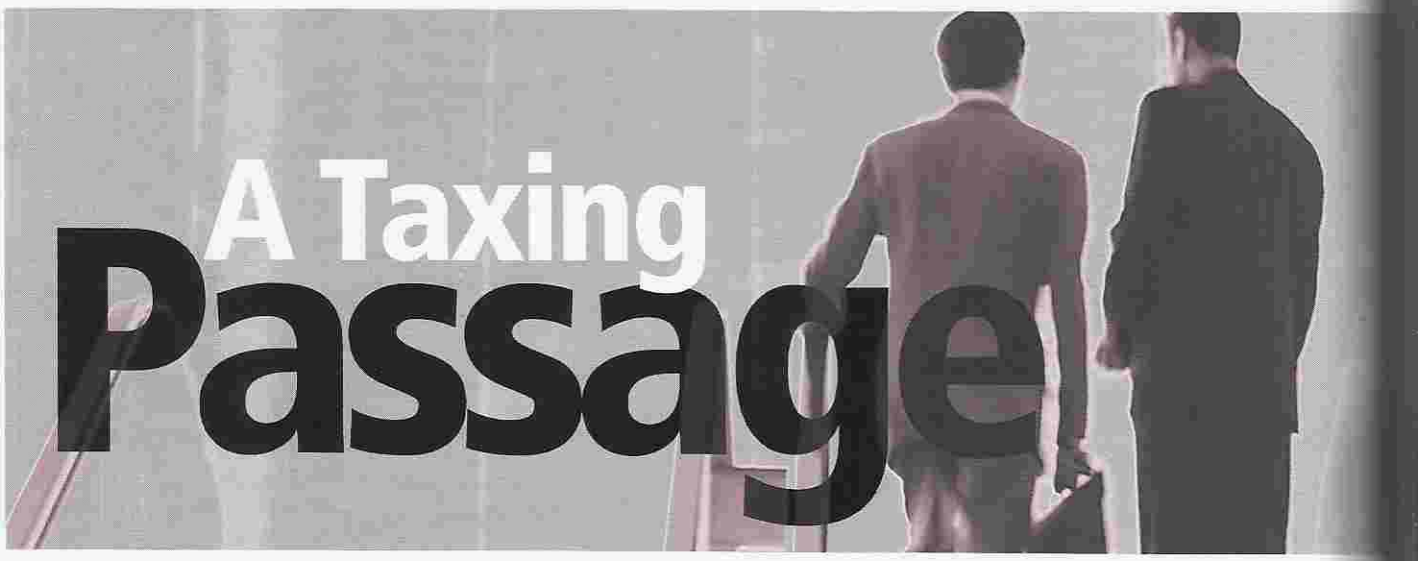


A Taxing Passage

By NAKHA RATNAM SOMASUNDARAM

Leave passage is a contradiction in Malaysian tax law. The recipient is not taxable[1] on the value of the leave passage – and the employer is not allowed a deduction for providing the passage. Recently the Inland Revenue Board (IRB) issued a Public Ruling[2] to explain the treatment of 'Leave Passage' for income tax purposes. This article seeks to examine the Ruling as regards leave passage in relation to the law, its scope and interpretation for tax purposes.

Employers provide leave passage as reward to employees. The recent trend however, is for employers to include leave passage as a standard feature of the remuneration package in employment contracts.

It can take several forms – the employee would be given a fixed sum to be used for a trip anywhere; or the employer will arrange with a tour or travel agency to provide the passage to his employees for an agreed sum.

Leave passages are included in the employment contracts to combat job-hopping or alternatively retain employees (and with it his or her experience), and generally provide a motivation for better production and output while building teamwork and company loyalty.

Even supplier-dealer relationship includes a leave passage arrangement. For example, a tire dealer or an insurance agent who achieves a pre-set target will be given a fully paid holiday trip.

For tax purposes, the issue is the taxability of the leave passage benefit to the employee and the deductibility of the leave passage expenditure to the employer, in the context of an employment.

Employment – The Legal Framework

What is an employment?

Under sec. 2 of the *Income Tax Act 1967* (as amended) (ITA) an "employment" means:

(a) employment in which the relationship of master and servant subsists;

(b) any appointment or office, whether public or not and whether or not that relationship subsists, for which remuneration is payable.

An "employer" means:

(a) where the relationship of master and servant subsists, the master;

(b) where the relationship does not subsist, then the person who pays or is responsible for paying any remuneration to the employee who has the employment, notwithstanding that the person and employee may be the same person acting in different capacities.

The term "employee" is defined to mean:

(a) where the relationship of master and servant subsists, the servant;

(b) where the relationship does not subsist, the holder of the appointment or office, which constitutes the employment.

1 There are some limits imposed on the exemption, which is discussed in detail in the later part of the article.

2 Public Ruling No. 1 of 2003 issued on 5 August 2003 to be effective from the year of assessment 2003.

3 For a discussion of various tests, see *Dr. Veerinderjeet Singh*, Malaysian Taxation –Administrative and Technical Aspects, 6th Ed. (Petaling Jaya: Longman, 2003) pp.473-475

4 [1969] 2 QB 173

5 18 TC 198

Existence Of An Employment

The question of whether an employment exists or not, is a question of fact. Over the years, several tests has been developed which are applied to determine the existence of an employment[3]. These tests take into account some of the following factors:

a. Control a person as in the manner in which the services is to be discharged;

b. Provision of tools and equipments;

c. Degree of skill and powers to delegate;

d. Hiring of helpers and assistants;

e. Degree of financial risks;

f. Responsibility for management; and

g. Opportunity for profit participation.

It is important to distinguish between a contract *of* service and a contract *for* service. The factors listed out above do not prove anything by themselves, but are merely indicators. In reality making a distinction between a contract of service and a contract for service, is rather difficult. As per *Cook* J in *Market Investigations Ltd v Minister of Social Security*[4] no exhaustive list may be compiled of the considerations which are relevant in determining whether or not a taxpayer is employed or self-employed. Different considerations and weightage have to be given to the various factors in a particular case.

The difficulty in distinguishing between a contract *of* service and a contract *for* service was brought out by the case of *Davies v Braithwaite*[5]. In this 1933 case, the professional activities of an actress included stage, film, radio and gramophone recording performances both in the United Kingdom and in the United States. The question for the court was whether she was carrying on a **profession** or is exercising an **employment**. The taxpayer claimed that she was in fact carrying on a series of employment (as compared to a single employment), but the court held that she was in fact carrying on a single profession. Per *Rowlatt* J:

"*...Each of these engagement cannot be considered an employment, but is a mere engagement in the course of exercising a profession...*'

Taxation Of Benefits In Kind

Under the ITA, income from a source consisting of an employment is taxable. It includes benefits or amenities provided for the employee by or on behalf of the employer[6]. These must be taken into account in determining the taxable income of the employee. These benefits or amenities will include those provided for the wife, servants, dependents or even guests of the employee. The benefits or amenities must be those that are *not convertible to money*[7]. Such benefits or amenities will include the provision of a car, servants, free food, free garments or even free legal assistance!

In one case[8], a company arranged for a Christmas present for its male employees, to be supplied clothing up to a cost of £15. The employees were given a letter to a tailor, on production of which the tailor invoiced the company for the cost. It was held by the courts the value of the clothing should be assessed on the employee, the taxable value being the resale value of the clothing (and not its cost to the employer).

In another case[9], the company paid the legal fees of an employee who was charged for a motoring offence. With the consent of the employee, the company took over the whole conduct of the case, because the employee was very valuable to the company. The total legal cost incurred by the company on behalf of the employee was held to be a benefit in kind to the employee and accordingly taxable.

Exemption Of Leave Passage

But provisions exist for exempting certain income and benefits. One of them is leave passage. Under sec. 13(1)(b)(ii) of the ITA, the following benefit or amenity is excluded in determining the income from employment:

13(1)(b)(ii) A	leave passage for travel within Malaysia not exceeding three times in any calendar year; or
13(1)(b)(ii) B	one leave passage for travel between Malaysia and any place outside Malaysia in any calendar year, limited to a maximum value of RM3,000

It will be observed that the law envisages two types of passages, one local and one overseas. In the case of the local passage, the number of such passages is extended to three and there is no limit to the quantum of the value.

The overseas passage is however restricted to only one such passage and the quantum of the benefit is restricted to RM3,000 in a calendar year (a calendar year here refers to the period from January to December and not any 12 month period).

The examples below are adapted from the examples given in the Ruling:

Example 1

En Karim was entitled for three trips within Malaysia. The employer paid for these trips. En. Karim, his wife and two children went to Langkawi, Pulau Tioman, and Kuching during the year. The total cost was RM9,800.

En. Karim will ***not*** *be taxed on the value of RM9,800 being the leave passages he enjoyed, because the total number of leave passages did not exceed three. The value of the trips is not material.*

6 Section 13(1)(b) of the *Income Tax Act 1967* (as amended)

7 The Income Tax Act 1967 (as amended) distinguishes between a benefit or an amenity convertible into money and those that are not. Benefit or amenity convertible into money will fall to be assessed under sec. 13(1)(a) while those not convertible into money will fail to be assessed under sec. 13(1)(b). On the other hand, the provision of living accommodation by the employer, which is not convertible into money, falls to be assessed under sec. 13(1)(c), the value of which is determined in accordance with the provisions of sec. 32(2) and 32(3).

8 Wilkins v Rogerson [39 TC 344]

9 Rendell v Went [41 TC 641]

Example 2

En. Mahendran and his wife went for a holiday to the following places, all of which were paid for by Mahendran's employer, under the terms of his employment contract.

Places visited	Cost (RM)	Note
Pulau Sipadan	3,800	Exempted
Genting Highlands	2,500	Exempted
Langkawi	2,000	Exempted
Kota Bahru	1,100	Taxable
Total cost of leave passages	9,400	

En. Mahendran will be exempted only on the three local leave passages. Since he had taken four leave passages, he will be exempted on the first three most expensive leave passages. He will be taxed on the lowest value of the four leave passages – in this instance the passage to Kota Bharu.

Example 3

En. Tan Siew Chin, a company secretary, was given a leave passage to Beijing, which was part of his employment contract. The total cost was RM3,000.00

Mr. Tan will not be assessed on the value of the benefit consisting of the trip because it was only one trip, and the cost did not exceed RM3,000.00.

If the employer gives more than one overseas trips, then the Ruling states that the higher or the highest value (if there is more than one leave passage) of the leave passage will be exempted, subject to a maximum of RM3,000.

Example 4

Mr. Nathan was entitled to two free trips under his employment contract with his employer. The first trip was to Hong Kong, costing RM2,900. The second trip was to Manila costing RM1,500.

En. Nathan will be exempted from tax on the trip to Hong Kong (being the higher of the two leave passages). He will be taxed on the benefit of the Manila trip.

Example 5

En. Johan was given two overseas trips by his employer for exceeding his sales target. The first trip was to South India, and the cost to the employer was RM2,800. He went on another trip to the United States and this cost the employer RM7,000.

En. Johan will be exempted from tax on the trip to the United States, being the higher cost of the two leave passages, up to a maximum limit RM3,000. He will be taxed on the balance, in addition to the value of the trip to South India. The taxable amount will be calculated as follows:

Trip to South India		2,800
Trip to United States	7,000	
Less: Exemption (maximum)	3,000	4,000
Amount of benefit taxable		6,800

Immediate Family – How Immediate?

The leave passage benefits are confined to the employee and members of his immediate family. The Ruling defines " members of his immediate family" to mean his wife, or wives, and his children, or her husband and her children

In one of the example provided in the Ruling,[10] the taxpayer took his father to Australia on a trip provided by the company. He did not qualify for an exemption on the amount spent on the father, even though the company gave the benefit to him. This is because the father is not a member of his immediate family.

Example 6

En. Wee was entitled to one free trip to Medan provided by his employer. He went there with his father and mother. The total cost was RM3,000 (i.e. RM1,000 per person). The employer paid the total cost.

En. Wee will be exempted on the value of the overseas trip to the value of RM1,000, but will be taxed on the balance of RM2,000 (RM1,000 for the benefit of the leave passage enjoyed by the father and another RM1,000 enjoyed by the mother). This is because the concept of 'immediate family' does not include parents!

Had En. Wee taken along his wife and children with him (instead of the parents, he will qualify for the exemption of RM 3,000 (max) because his wife and children will be considered as part of his immediate family.

All In The Family

The ITA seems to have different concepts of family to suit its own purpose and needs. Some examples are as follow:

1. In sec. 46, which allows personal relief, a sum of eight thousand ringgit is allowed for himself and *'his dependent* ***relatives***'. The term "*relative*" is not defined. I suppose that is a relative matter!
2. In the same section, a sum of up to RM5,000 is allowed as a deduction for medical expenses incurred on his *parents*.
3. Another subsection in sec. 46 allows a deduction for any expenditure incurred in providing basic supporting equipment for the use of ...*parents*.
4. In sec. 65(11), in relation to a settlement, the term **relative** is defined to mean a **child** of the settlor (including a **step-child** and **adopted child**), **grandchild**, **brother**, **sister**, **uncle**, **aunt**, **nephew**, **niece** or **cousin** of the settlor.
5. In sec. 139 which deals with exercising a controlling interest in a company, a term "associate" is used, which is then defined to include "*a persons in any of the following relationships to that person, that is to say,* **husband**, or **wife**, **parent** or **remote forebear**, **child** or **remote issue**, **brother**, **sister** and **partner**..." In effect, the definition appears to include all in the family!

10 Example No 5 in Para. 9 at page 3 of 5

Deduction Of Leave Passage Expenditure For Employers

Section 33 of the ITA sets out the general rules that govern deductions from gross income i.e. all outgoings and expenses wholly and exclusively incurred in the production of gross income from a source of income.

Section 39 of the ITA on the other hand prohibits the deduction of certain types of expenditure from the gross income. Expenditure incurred in the provision of a benefit or amenity by the employer to his employee consisting of a leave passage within or outside Malaysia is one of them [sec. 39(1)(m)].

The Ruling explains that where leave passage cost paid by the employer to the employee included costs of food, accommodation or other incidental expenses, only the amount relating to **fares** is treated as leave passage cost.

In other words, the cost of food and accommodation is deductible in arriving at the adjusted income of the employer's business. Under Para 10.3 of the Ruling, this however, is restricted to the amount spent on the employees only.

Thus, if the employee is given a leave passage and he takes his wife and children, then the amount the employer can claim as a deduction under the Ruling is only the cost of the meals and accommodation incurred for the employee only. The cost of the meals and accommodation incurred on the wife and children will not be deductible.

Example 7

Dr. Jeya is entitled to a free overseas trip under a contract of employment with Sunway Tires Sdn. Bhd. He went to Australia with his wife and four children. The expenditure incurred was as follows:

Expenditure type	Wife and children	Self	Total
Airfare	3,000	1,800	4,800
Meals	3,700	750	4,450
Accommodation	1,500	500	2,000
Total Expenditure	8,200	3,050	11,250

Taxation of benefit on employee

The benefit enjoyed by Dr. Jeya is RM11,250.00.

Since this is an overseas trip, an amount of RM3,000 (maximum value) will be exempted in determining his income from employment.

Deduction for employer

Sunway Tires Sdn. Bhd. can claim the following expenditure as deduction against its gross income from business, in respect of the leave passage given to En. Jeya:

Expenditure	Amount (RM)
Meals	750
Accommodation	500
Total sum claimable as a deduction	1,250

The expenditure incurred on Dr. Jeya's wife and children cannot be claimed.

Leave Passage: Sole Proprietors And Partners

Paragraph 11 of the Ruling states that leave passage benefit provided to a partner or sole proprietor will not qualify for tax exemption. The reason being the condition whereby the leave passage benefit is confined to the employee is not fulfilled since the relationship between a partner and a partnership, or the sole proprietorship to himself, is unlike the employer-employee relationship as defined in sec. 2 of the ITA.

In the case of a partnership or a sole proprietorship, the expenditure incurred on leave passage cost to the partner or to the sole proprietor will not qualify for deductions, being regarded as private in nature. Thus, no part of the expenditure claimed is allowed in computing the partner's share of the partnership income or the sole proprietor's adjusted income of his business.

Leave Passage: Directors Of Controlled Company

No mention however is made about directors of a controlled company. Unlike a sole proprietorship or a partnership, directors of a controlled company do enjoy the master-servant relationship *viz a viz* themselves and the company, the company being a separate and different entity[11]. However, the level of control is no different from that of a sole proprietor and his business or that of a partner and the partnership.

Review Of Selected Case Laws

The amendment disallowing leave passage came into effect only from the year of assessment 1989[12]. Even before the amendments, the deductibility of leave passage was a litigious issue. Two cases, (decided before the amendment came into force) one in which the leave passage expenditure was disallowed, and another in which the expenditure was allowed, are reviewed below to understand the thinking of the Special Commissioners and the High Courts on the matter of leave passage.

ST Sdn. Bhd[13]

S. T. Sdn. Bhd. (the company) was set up to provide consultant medical services and operated a clinic. It engaged one Dr. McCoy, a medical specialist, as its consultant and advisor in relation to medical matters. Under the terms of the engagement, Dr. McCoy

11 The separate entity concept was established in the case of *Salomon v Salomon & Co.* (1897) A.C. 22

12 Income Tax (Amendment) Act 364 of 1988, effective from the year of assessment 1989.

13 ST Sdn Bhd. v Ketua Pengarah Hasil Dalam Negeri [(1999) MSTC 3051]

is entitled (among other things) to a leave passage for himself and his family from Malaysia to the United Kingdom annually. The Revenue disallowed the leave passage cost to the company. An appeal was filed with the Special Commissioners.

Since this case came up before the amendment to sec. 39 disallowing leave passage, the issue before the Special Commissioners was whether the cost of leave passage provided by the company to Dr. McCoy and his family was an expense wholly and exclusively incurred in the production of gross income. The Revenue had contended that it was not and therefore not an allowable deduction under sec. 33(1) of the *Income Tax Act 1967* (as amended). The taxpayer contended that this expenditure for leave passage to the United Kingdom formed part of the remuneration package.

The Special Commissioners however held that the leave passage was not incurred in the production of gross income, and that for a deduction to be granted, it must be shown that the said expenditure produced gross income. Consequently, the deduction claimed was disallowed.

KHK Advertising[14]

KHK Advertising Sdn. Bhd. (the company) had entered into a service agreement with three of its directors. The service agreement entitled the directors and their families to leave passage once in every two years. The company incurred the cost of the leave passages for the years 1983, 1984, 1985 and 1986 and claimed the expenses for the relevant years of assessment. The expenses were disallowed by the Revenue.

On appeal, the Special Commissioners disallowed the claim. The company appealed to the High Court and argued that:

a. The expenditure was not prohibited by sec. 39 of the ITA (note that this was before the amendment to that section in the year 1988);

b. It was wholly and exclusively incurred in the production of gross income under sec. 33(1) i.e. the section that allows deduction to be claimed.

c. The proper question to be addressed is: *Whether the services provided by the employees were in the production of gross income for which the compensation was paid, which included the free passage.*

It was the Revenue's argument that the air passage was "private and vacational" as a term of contract between the company and the directors. Being "private and vacational" the cost of leave passage was not wholly and exclusively incurred in the production of gross income.

The High Court allowed the company's appeal. In giving judgment, the court made some (sensible) comments, which are significant, and for that reason is reproduced below:

a. The proper issue was what compensation was given for the services rendered. The Special Commissioners laid emphasis on how the employees spent their compensation. The free passage was one of the components of the remunerating package. It did not matter that the employee visited some of the countries of his choice.

b. The Special Commissioner stated that the company had failed to show that the leave passage contributed to the production of gross income. The High Court felt that this was a misdirection by the Special Commissioners. In fact, the relevant question to be asked is not whether the *leave passage* contributed to the production of gross income but whether the *employees* contributed anything towards the production of gross income. The free passage was part of a reward to the employee, and it was a cost to the employer in respect of the services rendered.

The High Court also referred to the earlier case of *S Sdn. Bhd*[15] and remarked that the said case, which decided that private and vacational expenses could not be wholly and exclusively incurred in the production of gross income, was wrongly decided because how an employee expended the compensation paid by the employer, was not an issue. In the light of the above comments on *S Sdn. Bhd.*, it would be appropriate to review that case here.

S Sdn. Bhd.

S Sdn. Bhd. (the company) operated a medical clinic. The company's governing director was one Dr. Yeo, who was also the *sole* shareholder of the preference shares. The company agreed to make payments to Dr. Yeo '*as remuneration for the services*' which among other things included air fares for Dr. Yeo and his family once every two years from Malaysia to the United Kingdom. The Revenue disallowed the claim of the airfares for Dr. Yeo and his family.

The case went to the High Court where it was decided that:

a. The so-called employment agreement referred to the company as the "employer" and Dr. Yeo as the holder of an appointment of consultant, which constituted the employment.

b. The company was responsible for the payment of the remuneration, notwithstanding that the Dr. Yeo and the company were the *same persons acting in different capacities.*

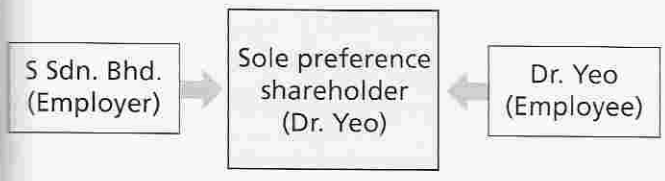
c. On the same grounds, the leave passage being private and vacational in nature, the airfare expenses were treated as not wholly and exclusively incurred in the production of gross income.

14 *KHK Advertising Sdn. Bhd. v Ketua Pengarah Hasil Dalam Negeri* [(2001) MSTC 3,845].
15 *S Sdn. Bhd. v Director-General of Inland Revenue* [(1995) 2 MSTC 3,440]
16 For a detailed discussion of tax avoidance and tax evasion, see 16 Dr. Jeyapalan and Dr. Bala Shanmugam. *Taxation in Malaysia: Assessment, Compliance and Investigation* (Alor Setar: 1997).
Also see Nakha Ratnam Somasundaram, "Tax Evasion and Tax Investigation – A Study on Tax Compliance Management" *Chartered Secretary Malaysia*, July, 2003 pp. 20-23

S SDN. BHD – EVASION OR AVOIDANCE?

S Sdn. Bhd. is an interesting case because it came as close as it can to the very thin (and dangerous) line separating evasion and avoidance[16]. The court acknowledged that the company (S Sdn. Bhd.) and the employee (Dr. Yeo) are different person or entities, following the principle established in the *Salomon case*, but also acknowledged that they are the *same person* acting in different capacity *(see the definition of "employer" above)*

The situation can be expressed diagrammatically as follows:



Why was the taxman so reluctant to allow the leave passage expenditure?

Assume that Dr. Yeo was working as an employee with a private medical centre. He has no share interest in the medical centre other than his contract of employment. He receives a salary of RM5,000 per month. At the end of the second year of his employment, he goes for a two-weeks holiday with his family to the United Kingdom. The total sum expended was RM10,000.

Dr. Yeo cannot claim the cost of the leave passage as a tax-deductible expenditure from his employment income. It was a private and domestic (or vacational) expenditure.

But if Dr. Yeo sets up a company in which he is the sole shareholder (or shareholder with a controlling interest), and using the entity concept, arranges for an employment contract with the company, under which he is to be paid a salary of RM5,000 per month AND be given a leave passage to the United Kingdom once every two years, the tax equation changes. In this instance, it is obvious that the income earned by the company is actually income earned by Dr. Yeo. However, the company can now pay out a salary of RM5,000, which is now an expense to the company. It can also provide a leave passage to Dr. Yeo and claim that too, as an expense.

The leave passage expenditure is now company expenditure, allowed as a deduction against the company's income. It is not a private and domestic (or vacational) expenditure anymore; in addition, Dr. Yeo is not taxable on the leave passage (under the exclusion provision of the employment income in sec. 13).

The situation in *S Sdn. Bhd.* simply highlights the fact that with careful planning, it is possible to maximize one's benefit without any conflict with the tax law. However, the High Court did not see it that way in that case, and the decision was given against the taxpayer. Perhaps the arrangement was too transparent.

However, the subsequent decision in *KHK Advertising* proves that the decision was indeed wrong in law (at least before the amendment came into effect).

It is probably time for a review of the income tax legislation as regards the exemption of leave passage to the employees, and the deduction of its cost (fares in particular) to the employer, in the interest of the Malaysian economy.

Conflict in the law?

The issue, apparently, is one of conflicting laws. In sec. 33, the law provides for the ascertainment of the adjusted income "by deducting from the gross income of that person ...all outgoing and expenses wholly and exclusively incurred during that period ...in the production of gross income..."

Payment of wages, salary, remuneration, leave pay ...(whether in money or otherwise) to employees are expense that are considered to be incurred in the production of gross income. Section 13 which deals with the types of receipts that would constitute employment income also provides for the exclusion of certain benefits including leave passage.

On the other hand, sec. 39, which prohibits certain expenditure, includes leave passage provided for the employee. If the leave passage is part of employee's remuneration, it stands to reason that the expenditure incurred on the employee is truly expenditure wholly and exclusively incurred in the production of gross income. *KHK Advertising* has proven that this reasoning is logical.

However, Para 10.1 of the Ruling states that 'any expenditure incurred in the provision of a benefit or amenity by the employer to his employee consisting of leave passage ...is not deductible ...as it is specifically disallowed under sec. 39(1)(m) of the *Income Tax Act 1967* (as amended).'

Conflict With National Policy?

The Minister of Culture, Arts and Tourism is intent on promoting tourism, and encourages locals to travel within the country. This is one of the reasons why Government servants are given the first and third Saturday off. An effective way to achieve this is for the employers to provide such travelling packages in the remuneration deal.

The Malaysian Government's Pre-emptive Stimulus Package announced on 21 May 2003 consisted of several specific measures aimed at assisting and/or promoting affected industries. One such measure was a *double deduction to employers* for cost of leave passage for domestic travel provided to employees for a period of one year from 1 June 2003.

Note: Reprinted with permission from the Chartered Secretary Malaysia, October 2003, the journal of the Malaysian Institute of Chartered Secretaries and Administrators.

Conclusion

The Ruling, while enabling a better understanding of the tax treatment of leave passage, does not address the core issue of its deductibility for the employer.

At present the provisions of sec. 39 of the ITA denies the full deduction of the cost of a leave passage (i.e. it only allows the cost of food and accommodation expended on the employee, but excludes fares), and in so doing denies employers the additional opportunity of rewarding their employees in ways other than merely increasing their salary or bonus (which brings about its own financial consequences to the employer).

Leave passage has the potential to bring into full swing the economic dynamics of multiplier and accelerator effects into the economy, particularly the service sector, assisting and enabling industries like hotels, transport and tourism to flourish, and with it create employment opportunities, and general prosperity for Malaysians, directly and indirectly.

It is probably time for a review of the income tax legislation as regards the exemption of leave passage to the employees, and the deduction of its cost (fares in particular) to the employer, in the interest of the Malaysian economy. The concept of family in the ITA, for leave passage purposes, should also be reviewed to include members of the family like parents, brothers and sisters (besides the wife and/or husband and children) of the employee[17].

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[17] The views expressed are those of the writer.

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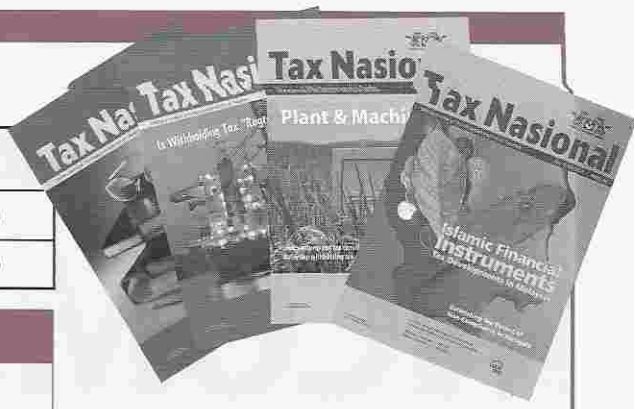

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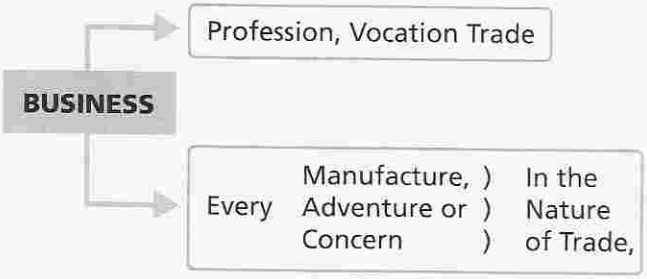
BUSINESS$$ INCOME

By SIVA NAIR

In the last two articles, we discussed the different methods of determining the basis periods on commencement of business and on the occasion where a company changes its accounting date. In this article, we will commence our study of the taxability of business income.

DEFINITION

Section 2 of the Income Tax Act 1967 (as amended) (the Act) defines the business to include a profession, vocation and trade and every manufacture, adventure or concern in the nature of trade, but excludes employment.



In our earlier article on employment, we had analysed features which enable us to distinguish between a profession and an employment. The significance in doing this was that the exercise of a profession was the conduct of a business as is clear from the definition of the word business above.

The word profession is not defined in the act but an inference can be drawn from the words of the learned *Srutton*, L.J in the case *I.R.C. v Maxse ([1919] 12 T.C. 41)*:

".....a 'profession' in the present use of language involves the idea of an occupation requiring either purely intellectual skill, or of any manual skill, and in painting and sculpture, or surgery skill controlled by the manual skill of the operator, as distinguished from an occupation which is substantially the production, or sale, or arrangements for the production or sale of commodities. The line of demarcation may vary from time to time. The word 'profession' used to be confined to the three learned profession – the Church, Medicine and Law. It has now, I think, a wider meaning."

Therefore, a profession involves the exercise of an intellectual skill. You and I may be able to argue about our innocence in a particular case outside a court but doing it in accordance with the protocol of a court proceeding can only be undertaken by a qualified advocate.

Alternatively, a profession may also be a manual skill controlled by intellectual skill. Both the butcher and the surgeon cut up flesh. In the former case, the animal is already dead but in the later case it is hoped (coupled with a fervent prayer!!) that the "being' under the scalpel will come out alive.

Similarly, the word vocation is not defined in the Act. The dictionary meaning encompasses "the occupation or calling that one follows". While it is possible that an individual pursuing a vocation may not have a profit-making motive, the reason for including vocation in the charging provisions could well have the desire to bring to tax any gains or profits arising from an activity which though predominantly motivated by spiritual and other non-monetary gains does in fact give rise to a monetary gain or profit as a minor consequence.

In *Billam v. Griffith (23 T.C. 757)*, a barrister who was a full-time employee wrote a play during his spare time which was produced and bought for a film for which he received a lump sum as an advance for royalties. It was held that the sum was assessable as arising from a vocation.

Trading generally "involves something in the nature of a commercial undertaking, of which the buying and selling are the most obvious characteristics" (*I.R.C. V Forth Conservancy Board 16 T.C. 103,116.*). The following are the features of trading:

- involves buying and selling
- consists of a series of transaction, having continuity and repetition
- would include even an isolated transaction
- reflected by the intention at the time of acquisition, which may change

From the next limb of the definition i.e. "every manufacture, adventure or concern in the nature of trade" it is obvious, that the word business has much wider meaning than the word trading.

This means that even activities that fall short of full trading operations but are sufficiently close to trading will qualify.

In *Leeming v Jones (15 T.C 333)* (and set out by *Gill F.J.* in the local case of *E. v. Comptroller-General of Inland Revenue [(1970) 2 MLJ 117])*, it was established that the following conditions is sufficient to establish the existence of an adventure or concern in the nature of trade

- the existence of an organisation
- activities which lead to the maturing of the asset to be sold
- the existence of special skill, opportunities in connection with the article dealt with
- the nature of the asset itself should lend itself to commercial transactions

So, whether a particular transaction falls within the ambit of trade or at least an adventure in the nature of trade became a hot topic for debate and argument. To provide some form of guidance and shed some light on this matter, a Royal Commission in the United Kingdom which had considered this matter at length, produced a Final Report containing six badges of trade. However, over the years various case law decisions have facilitated the creation of a few more badges.

BADGES OF TRADE

As opined by Awther Singh, these badges are no more than a guide to the considerations to be borne in mind when making a decision on whether or not a particular set of facts give rise to an adventure in the nature of trade. No one badge is conclusive in itself, and frequently the result will turn on a combination of more than one badge. Furthermore, the application of one badge may lead to one conclusion whereas the application of another may lead to another decision. In such a case, the question will turn to which badge is to be given more weight. It is generally accepted that badges are more significant than others.

PROFIT-SEEKING MOTIVE

In isolation this badge is not conclusive i.e. not all transactions resulting in a profit are taxable. As we have seen earlier, only revenue gains are subject to income tax. Therefore, capital gains arising from the sale of fixed assets or long term investments are not taxable although the sale generates a profit.

However, the profit seeking motive as an evidence of trade is more easily assignable to companies or partnerships rather than to an individual. It is indeed a rare situation where someone sets up a company without any intention to make profits.

Kwai Fatt remarks that where a company puts its assets to gainful use, in prima facie, amounts to the carrying on of a business. As such, although a company holds a property for a long period of time, proceeds on subsequent disposal may still be viewed as business income because the holding period may be construed as "waiting for the right opportunity to realise profits."

INTENTION

The intention of the disposer of an asset at the time of acquiring the asset would also be a relevant factor to consider. However, intention is an abstract state of mind. Therefore, to enable it to be presented as evidence in a court of law, it has to be converted into some tangible form as follows:

Documentation upon acquisition of the asset

Most business transactions are preceded by the preparation of numerous documents with details of the nature of the transaction, the estimated costs and anticipated benefits and the objective of undertaking it. This would shed some light on the intention at the point of acquisition.

Example 1

The Board of Directors of January Sdn. Bhd., passed a resolution on 31st January 2003 to purchase a piece of land in Rawang for putting up their head office. However, due to severe financial problems they were forced to abandon their initial intention and sell of the land which produced a profit, on the 15th of March 2003.

The gain would not be subject to income tax because the directors' resolution can be used as evidence that they did not have any intention to sell the land for a quick profit.

Classification in the financial statements

Stocks or short term investments purchased for the purpose of disposing at a profit at the earliest opportunity, usually liquidated within one accounting period are reflected as current assets whereas assets of enduring benefit or long term investments are reflected as fixed assets. Generally, profits arising from the realisation of the former are revenue gains and in consequence subject to income tax in contrast to the latter, where the gains on realisation are capital gains.

Example 2

Robmisun Bank Bhd. discloses two sets of investment in its balance sheet for the year ended 31st December 2003; one as short term marketable securities and the other as long term investments. Subsequent disposal of both the portfolios resulted in a profit.

The profit from the sale of the short term marketable securities would be taxable whereas those from the long term investments would be capital gains and therefore not taxable.

Inferred from surrounding circumstances

The Final Report stated:

"There are cases in which the purpose of the transaction of purchase and sale are clearly discernible. Motive is never irrelevant in any of these cases. What is desirable is that it should be realized clearly that it can be inferred from surrounding circumstances in the absence of direct evidence of the seller's intentions and even, if necessary, in the face of his own evidence"

The existence of a huge profit itself does not lend credence to the fact that it is taxable profits!

Example 3
Ms. Jan O'Hary purchased a piece of land in Sepang or Nilai twenty years ago for a very low price but sold it in recent years (without doing anything to the land) for an enormous gain. Should the gain be subjected to income tax?

Obviously not! Factors such as the Kuala Lumpur International Airport and the F1 motor racing circuit being built in the vicinity had contributed significantly towards the capital accretion of the piece of land which in consequence had led to the enormous gains.

METHOD OF ACQUISITION OF ASSET

Where an asset is inherited or received as gift, then profits arising from subsequent disposal would probably constitute non-taxable gains.

Example 4
Fab O'Harry receive the sad news that a long lost uncle of his had expired but this is followed by a delightful SMS that he has left him a bungalow worth a million ringgit!!

However, due to its remote location Fab decides to sell it off within a month from the date of receiving the title from his uncle's executors. The transaction resulted in a handsome profit.

The profit would not be subject to tax as Fab did not even purchase the bungalow.

NATURE OF SUBJECT MATTER

Sometimes an asset is purchased because it yields income. Properties are purchased with the intention of renting it out and receiving rental income and shares are held for the purpose of getting dividend income. Therefore, any gains arising from the disposal of such investments do not attract income tax.

Similarly some assets provide personal enjoyment or represent a prized possession and the eventual sale of such assets would not amount to trading. This could include a rare coin or stamp collection or jewellery, which may provide a lucrative profit on disposal but these profits are *prima facie* not taxable.

However, where the nature of the transaction and the subject matter it involves, lends itself to commercial activity then any gains arising from its realisation would attract income tax even though it was an isolated transaction.

In *CIR v Fraser (24 TC 498)*, a woodcutter who purchased a large consignment of whiskey held in bond and sold it at a profit was stamped as arising from an adventure in the nature of trade based on the following:

- **It was greatly in excess of what could be used by himself, his family and friends**
  The quantity of whiskey purchased itself lends evidence that it could not possibly be for personal consumption of the taxpayer and his family.
- **It is a commodity which yields no pride of possession**
  When you students graduate with your respective qualifications you will proudly display it after your name but you don't see someone placing behind his name "owner of whiskey" do you?
- **The commodity cannot be turned to account except by a process of realisation**
  Huge quantities of whiskey can provide only two benefits; either the pleasure of drinking it or a profit on resale. Since the first contention has already been disposed of earlier in this case, the purpose of acquisition must be resale at a profit.

In *Rutledge v CIR (14 T.C. 490)*, the taxpayer bought a million rolls of toilet paper and sold it at a substantial profit. It was held that the transaction was obviously for no other conceivable purpose other than that of reselling at a profit and therefore, was an adventure in the nature of trade.

Example 5
Mr. March, an accountant with an accounting firm, capitalised on a "Mega Sale" at a leading departmental store and purchased a million toothbrushes which were being offered at extremely cheap prices. He sold these for a higher price to friends and relatives.

Technically, his profit from the sale of the toothbrushes would be subject to tax.

MODIFICATION OF ASSET OR SUPPLEMENTARY WORK

"If the property is worked up in any way during the ownership so as to bring it into a more marketable condition or if any special exertions are made to find or attract purchasers, such as the opening of an office or large-scale advertising, there is some evidence of dealing."

Where any alterations or improvements are done to the asset to render it more marketable or merchantable or a concerted effort is made towards enhancing the profit that can be generated through organised activities such as advertising, promotions, employing staff or having a marketing team would be indicative of at least an adventure in the nature of trade.

In *Cape Brandy Syndicate v CIR (12 TC 358)*, three individuals formed a syndicate in order to purchase as a speculation a special quantity of brandy, and **realised** a profit on its disposal, which was over a period of 18 years. They argued that the profits were not taxable because

- This was merely the realisation of an investment, and
- That being an isolated and speculative transaction, it was not trade.

The courts, however, held that the gains were taxable on the following grounds:

- the activities included the blending of different types of brandy,
- the brandy was recasked and
- sold in lots to different purchasers

CIR v. Livingstone (11 TC 538) raised the issue that supplementary work on the subject-matter which alters the nature and identity of the subject matter points to a trading transaction whereas those which merely enhances its value and marketability, is not trading in nature.

The facts of the case are, a ship repairer, a blacksmith and a fish salesman's employee purchased a second-hand cargo vessel with the view of converting it to a steam drifter and selling it. Extensive repairs and alterations were carried out on the vessel and it was ultimately sold for a large profit.

Although it was a single transaction which took only three months to complete, it was held that the profit realised was taxable as arising from a trade because "the profit made by the venture arose not from the mere appreciation of the capital value of an isolated purchase for resale, but from the expenditure on the subject purchased of money laid out upon it for the purpose of making it marketable at a profit. That seems to me to be the very essence of trade."

One of the reasons put forward by the judge was that

" to determine whether a venture such as we are now considering is, or is not, "in the nature of trade" , is whether the operations involved in it are of the same kind, and carried on in the same way, as those which are characteristic of ordinary trading in the line of business in which the venture was made.....these operations seem to me to be the same as those which characterise the trade of converting and refitting second-hand articles."

Similarly in *Martin v. Lowry (11 TC 297)*,the taxpayer purchased in one transaction 45 million yards of surplus aircraft linen. The profits arising from their ultimate disposal were held to be assessable to tax because the taxpayer:

- set up a sales organisation office
- engaged staff to advertise and sell the linen
- sold the linen in numerous lots

Example 6
Mr. Aye Peril purchased a piece of agricultural land in Rawang. He applied for and successfully obtained approval to convert the land to industrial land after 2 years. Activities ***involving alienation and subdivision*** *were* ***also undertaken. Subsequently,*** *the land was disposed of for a profit.*

Although the transaction may be an isolated transaction it would be subject to tax prima facie based on the supplementary works undertaken.

LENGTH OF OWNERSHIP

Generally, a longer period of ownership would abate the chances of any profit realised on disposal as being construed as trading. However, no length of time can be laid down as a hard and fast rule in determining what is the "sufficient period of holding" which would suffice to remove any gains on realisation from the ambit of income tax.

A further limitation of this badge is that different lengths of ownership may apply for different subject-matters. Shares, for example, are normally turned over within a shorter period of time compared to land.

In *Wisdom v Chamberlain (45 TC 92)*, the purchase of silver ingots as a hedge against an anticipated devaluation and sold at a profit within less than a year were held to be trading income.

The judge in *Earmes v Stepnell Properties Ltd.* remarked:

"one element at least of investment must be that the acquirer of the investment intends to hold it, at any rate for some time, with a view to obtaining either some benefit in the meantime or obtaining some profit, but not an immediate profit by resale."

In *Mount Elizabeth (Pte) Ltd. v The Comptroller of Income Tax (1987) 2 MLJ 130 (HC)*, the taxpayer developed a block of high-rise apartments and sold them with the exception of a few units. These units were retained for seven years and then sold. The profits arising from the sale of the retained units were still treated as trading profits.

FREQUENCY OF TRANSACTIONS

Repetitive transactions occurring in succession over a number of years would be a clear indication of a trading.

In *Pickford v Quirke (13 TC 251)*, the fact that if a pattern of constant dealing in the asset is established, it could be argued that all the transactions taken together constitute a "business" although each by itself may be an isolated non-business transaction.

Example 7
Mr. May bought one lot of shares in a public listed company in 1997. He sold the shares in 1999. In 2000, he purchased one lot of shares of another counter and disposed it for a profit after holding it for 18 months. Opportunity beckoned again in 2002 where he got to buy two lots of shares at a very good price. This last lot gave him a very handsome profit.

Each of these transactions may not be trading in nature. However, when taken collectively, it is literally impossible to disguise the trading feature.

CIRCUMSTANCES RESPONSIBLE FOR THE REALISATION

Impending acquisition by the Government

Example 8
Mr. Joon has a property in Ipoh which he has no intention of selling. However, to facilitate the development of a government project, the property was compulsorily acquired by the government. As the compensation paid for the affected areas was not attractive, Mr. Joon managed to sell the property to an unsuspecting buyer for a profit. The gains would not be subject to income tax.

Urgent need of cash for other trading operations

Example 9

Joo Lai Sdn Bhd. had purchased a piece of land. Unfortunately, the land had to be sold after a few months as the company's financial position had deteriorated tremendously and it was at the brink of being placed under receivership.

The disposal was obviously to save the company, and therefore, any gains arising are not subject to income tax.

Lack of capital to work the asset

Example 10

Mr. O'gast Construction Sdn Bhd purchased a sophisticated plant from Japan but was unable to use it because it did not know how to operate the machine. For the engineers to come down to Malaysia, it was not cost effective. Therefore, the company sold of the machine and made some profit on the sale.

The profits would not be subject to tax.

METHOD OF FINANCING

Generally, borrowings are reflective of purchase with a view of quick resale at a profit because the person would be confident of prompt settlement of the debt (thus minimising interest cost) by using the sale proceeds.

Of course, when we purchase a house we normally try arranging for a loan. However, when the house is ultimately sold, after years of residence, any profits would constitute capital gains and not taxable profits.

Similarly, where money for purchase of asset is from the realisation of another investment then it is more indicative of a long term investment.

Example 11

Mr. Zebt Amber took a housing loan to purchase a link house for the residence of himself and his newly wedded wife. The loan is for thirty years. Based on the advice of his remisier friend, Dr. Barr, he also took a short term loan to capitalise on a new share issue which was anticipated to achieve a very good opening price. Subsequent disposal of both assets resulted in a gain.

In considering whether the profits should be subject to tax, the fact that their purchase was financed through borrowings would be irrelevant in the case of the house but relevant in the case of the shares.

DESTINATION OF PROCEEDS

This badge prompts the question "What happens to the profits arising from the disposal?" If they are ploughed back to purchase similar items, at least an adventure in the nature of trade, if not trading itself has definitely been established.

Example 12

Mr. D. Sembar, who owns a pub, the No Vamp Bar, decided to use his cash surplus to buy some shares. Soon after the purchase, he sold the shares making a handsome profit. He argued that the profit should not be taxable because he was forced to sell the shares, as he needed urgent funds to repair his pub after a drunken brawl took place at his bar.

However, if part of the sale proceeds were used to purchase further shares, then his hope of arguing that the profits arising from the sale should not be taxable will be further diminished.

To help students to remember the various badges of trade, two local authors have designed specific mnemonics to facilitate the memorising process as given below:

Dr. Veerinderjeet Singh

- **P** profit - seeking motive
- **A** acquisition method
- **N** number of transactions
- **T** type / nature of asset
- **O** organisation of asset
- **M** modification of asset
- **I** interval between purchase and sale
- **M** method of finance
- **E** existence of trading interests in similar field

Alan Yeo

- **P** purpose
- **R** repetition
- **O** organisation
- **F** financing
- **I** improvement
- **T** timing
- **S** surrounding factors
- **W** ways of disposal
- **I** interest in similar field
- **N** nature

For practice, students can refer to Question 3 (c) of Taxation IV paper in December 2001, where candidates were required to "discuss with reasons and by reference to case law as well as relevant statutory provisions" whether the disposal of a shophouse by a taxpayer was subject to income tax or real property gains tax.

Candidates were expected to state principles established in decided cases and apply the test for badges of trade to determine whether the isolated transaction would amount to an adventure in the nature of trade. In this question, the examiner had noted that:

- Candidates lacked the understanding that isolated transactions may be subject to income tax if the transactions amounts to an adventure or concern in the nature of trade.
- Candidates merely state the decided cases and the principles laid down therein but fail to apply them to the facts in this particular question.
- Profit seeking motive alone does not render a taxpayer to be subject to income tax.

This concludes the discussion on the definition of business income and an analysis of the badges of trade that are generally utilised to determine whether there is an element of trading in a particular transaction or at least whether it can be taken to be an adventure in the nature of trade.

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SOLUTIONS TO PRACTICAL EXERCISES FOR CHANGE IN ACCOUNTING DATE (Vol. 12/2003Q4)

Question 1

Obviously students would have noted that in this question Meteor Sdn. Bhd. has changed its accounting date:

- not from 31st December
- the period of change is more than 12 months
- the new accounts are ending in the third year

According to the rules prescribed in the relevant public ruling, the new accounting period will be apportioned equally and the two periods will be taken to be the basis periods for the first 2 years of assessment commencing in the failure year, which in this case would be 2002. Any fraction of a month will be treated as falling into the first period.

The basis periods for the relevant years of assessment will be determined as follows:

Year of assessment	Basis period
2001	01.12.2000 – 30.11.2001
2002	01.12.2001 – 31.07.2002
2003	01.08.2002 – 28.02.2003
2004	01.03.2003 – 28.02.2004

Question 2

In this question Galaxy Sdn. Bhd. has changed its accounting date from 31st December. Therefore, the basis period in the year of change is year ending 31st December.

The basis periods for the relevant years of assessment will be determined as follows:

YA	Basis Period	Adjusted Income (RM)
2001	Year ended 31.12.2001	50,000
2002	Year ended 31.12.2002	60,000 (Note1)
2003	Year ended 30.09.2003	72,000 (Note 2)

Note 1: RM36,000 + (RM96,000 x 3/12)
Note 2: RM96,000 less (RM96,000 x 3/12)

Galaxy Sdn. Bhd. has again changed its accounting date. (the fact that the change was to have the same year-end as the holding company is irrelevant here)

- not from 31st December
- the period of change is less than 12 months
- the new accounts are ending in the following year

The new accounting period is the basis period for the year of assessment in the failure year which in this case is 2004.

Therefore, basis periods for the relevant years of assessment will be determined as follows:

YA	Basis Period	Adjusted Income (RM)
2004	01.10.2003 – 31.08.2004	(34,000)
2005	Year ended 30.08.2005	55,000

FREE ZONES

A BOOST FOR EXPORT ORIENTED INDUSTRIES?

By THOMAS SELVA DOSS

Ask anyone living in Penang the whereabouts of a Free Trade Zone or FTZ as it was commonly known and they will direct you to Bayan Lepas. Bayan Lepas can proudly boast of being the biggest Free Zone in Malaysia (as it is currently known) consisting of four phases. But few people really understand the meaning of a Free Zone. Before 1990, there were only Free Trade Zones in Malaysia but after that year with the passing of the Free Zones Act 1990, we now have two types of Free Zones – the Free Commercial Zones and the Free Industrial Zones. So, what is the difference between the two?

Under the *Customs Act 1967*, *the Sales Tax Act 1972*, the *Service Tax Act 1975* and the *Excise Act 1976*, the Free Zone is considered to be a place outside Malaysia and therefore is subject to minimal Customs procedures. Being a place outside Malaysia, a Free Zone has a lot of benefits. First of all, let us see how a Free Zone comes into existence. Section 3(1) of the *Free Zones Act 1990* states that 'The Minister may, by notification in the gazette, declare any area in Malaysia to be a Free Commercial Zone or a Free Industrial Zone, and every such notification shall define the limits of such zone.' The Minister referred to here is the Minister of Finance, who is given the power to establish a Free Zone. Sub-section 2 further states that the Minister may appoint any statutory body, any Federal or State Government department, or any company as the authority to administer, maintain and operate any Free Zone. Once a Free Zone has been established, he will exercise his power to appoint a Zone Authority, which will be responsible for the Free Zone.

One of the first responsibilities of the Zone Authority will be to erect and maintain two parallel perimeter fences or walls along the boundary of the Free Zone with only one entry/exit for the movement of persons, conveyances, vessels and goods entering or leaving the Free Zone. It also has to erect a Customs office at the entry/exit point for the stationing of Customs officers. These fences or walls will clearly delineate the boundaries of the Free Zone.

The Zone Authority may require an operator in a Free Zone to maintain full and proper records of all activities carried out by the operators. These records may be inspected by a senior officer of Customs at any time. The Authority is also responsible to account for all goods brought into or taken out from a Free Zone.

Section 4 of the Act states goods and services of any description, except those specially and absolutely prohibited by law, may be brought into, produced, manufactured or provided in a Free Zone without payment of any Customs duty, excise duty, sales tax or service tax' but sec. 6 states that the Minister, may, by order published in the Gazette, exclude any goods and services from the provisions of sec. 4 and these goods shall become dutiable. This takes us to the next step of defining a Free Zone. As stated before under the *Free Zones Act 1990* there are two types of Free Zones – the Free Commercial Zone and the Free Industrial Zone. Let us take a look at the Free Commercial Zone first.

FREE COMMERCIAL ZONE

In a Free Commercial Zone, only commercial activity is allowed. Sections 2 of the Act states 'commercial activity' includes trading (excluding retail trade), breaking bulk, grading, repacking, relabelling and transit. Taking a closer

look, we see that apart from trading only minor processing is allowed in a Free Commercial Zone. Companies are allowed to import goods from overseas or purchase locally manufactured goods and store them in a Free Commercial Zone without the payment of customs duties, sales tax or excise duty. These goods can be traded (wholesale trade), broken into smaller lots, graded according to specifications, repacked into different packages, relabeled and so on. Judging from these definitions, we notice that a whole range of activities can be carried out in a Free Commercial Zone. For example, a company can import second hand refrigerators from Japan and strip the refrigerators (break bulk) into motors, casing, cooling coil, condenser and so on. The motors may be re-exported to say Indonesia, the cooling coils to Korea, the condensers to Thailand and so on as spare parts. The advantage in doing this is that the company can import the refrigerators from Japan and store them in a Free Commercial Zone, strip them into parts, pack them, label them, possibly grade them and then export the components or spare parts to the designated countries without the payment of customs duty or sales tax. If this process is carried out outside the Free Commercial Zone (i.e. inside the Principal Customs Area) then the company has to pay the customs duty and sales tax on the refrigerators, strip them, label them, grade them and classify each component under the correct tariff code before exporting them. The disadvantage is that no drawback (refund) of import duty and sales tax paid at the time of import will be allowed on the components or parts exported. This will definitely increase the cost of doing business.

Only manufacturing companies can be located in a Free Industrial Zone (FIZ) and they must conform to the definition of manufacture under sec. 2 of the Customs Act. All of the manufactured goods must be exported.

The Malaysian Government has established a number of Free Commercial Zones throughout Malaysia to facilitate trade. Some have special facilities. For example, in the Stulang Laut Free Commercial Zone in Johor Baru, the Minister of Finance has exercised his powers under sec. 6A of the Act to authorise retail trade. This Free Commercial Zone houses a shopping complex retailing duty free goods as well as a 5-star hotel. The goods can be purchased and consumed inside the zone without the payment of import duty, sales tax or excise duty. Try to take them out of the zone and you will have to pass through a Customs checkpoint where you will have to declare those goods and pay the taxes and duties involved. Whereas the Free Commercial Zone in Butterworth, Penang is inside the Penang Port comprising of a bay for containers where the boxes can be transshipped. In fact, the main objective of a Free Commercial Zone is for the transit and transshipment of goods. One must bear in mind, that although no customs duty, sales tax or excise duty is payable for goods stored in a Free Commercial Zone, the proper declaration forms must be filled in and submitted to Customs.

The Free Commercial Zones and the Free Industrial Zones.

So, what is the difference between the two?

FREE INDUSTRIAL ZONE

Only manufacturing companies can be located in a Free Industrial Zone (FIZ) and they must conform to the definition of manufacture under sec. 2 of the Customs Act. All of the manufactured goods must be exported. The Minister, in certain circumstances and after imposing conditions may allow certain companies to sell part of the goods manufactured in the domestic market, subject to the payment of import duty and sales tax. What facilities can a manufacturing company in the FIZ enjoy? They can purchase all equipment and machinery which are directly used in the production process free of import duty and sales tax. Caution must be exercised to ensure that the equipment and machinery granted exemption must be 'directly' used in the production of manufactured goods. Equipment or machinery which are not directly used, will not be given exemption. Things like air conditioners, refrigerators, hi-fi equipment, vacuum cleaners, motor vehicles and forklifts are not given exemption. The same goes for furniture or fittings. In addition to this, all raw materials or components which are directly used in the manufactured goods are also given exemption from import duty and sales tax. The advantage is that these manufacturing companies do not have to apply for any exemption. They can purchase the equipment and machinery as well as raw materials free of import duty and sales tax any time of the day throughout the whole year. Also, they are allowed to run their production lines twenty-four hours a day. The companies that are located in a Free Industrial Zone are mostly multinationals producing for the export market but we can also see a number of local companies there. One obvious sight is the Customs office at the entrance of the zone which is manned by Customs officers twenty-four hours a day. This enables the movement of goods; especially the much needed raw materials, into the FIZ without any restrictions. However, they have to be declared on the relevant customs declaration forms and submitted to the Customs at the entrance before they are allowed inside the zone. Another advantage is that these companies are not audited by Customs, although they are required to maintain full and proper records of all their activities.

One pertinent point to note is that goods which are specifically and absolutely prohibited under the Customs (Prohibition of Imports) Order 1998 and Customs (Prohibition of Exports) Order 1998 cannot be brought into a Free Zone.

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- MASB 7 Construction Contracts
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Danny Tan is currently a Partner of a firm providing financial training and consulting for firms in public practice and industry. He has over 20 years of experience in public practice, as well as in commerce and industry. He is a regular speaker in financial reporting, auditing and corporate financial management for several professional institutions and government departments. He lectures extensively for various universities both at home and abroad including Universiti Sains Malaysia, University Abertey Dundee, UK and Heriot-Watt University, UK. At present, he is serving as a Project Manager for the Malaysian Accounting Standard Board.

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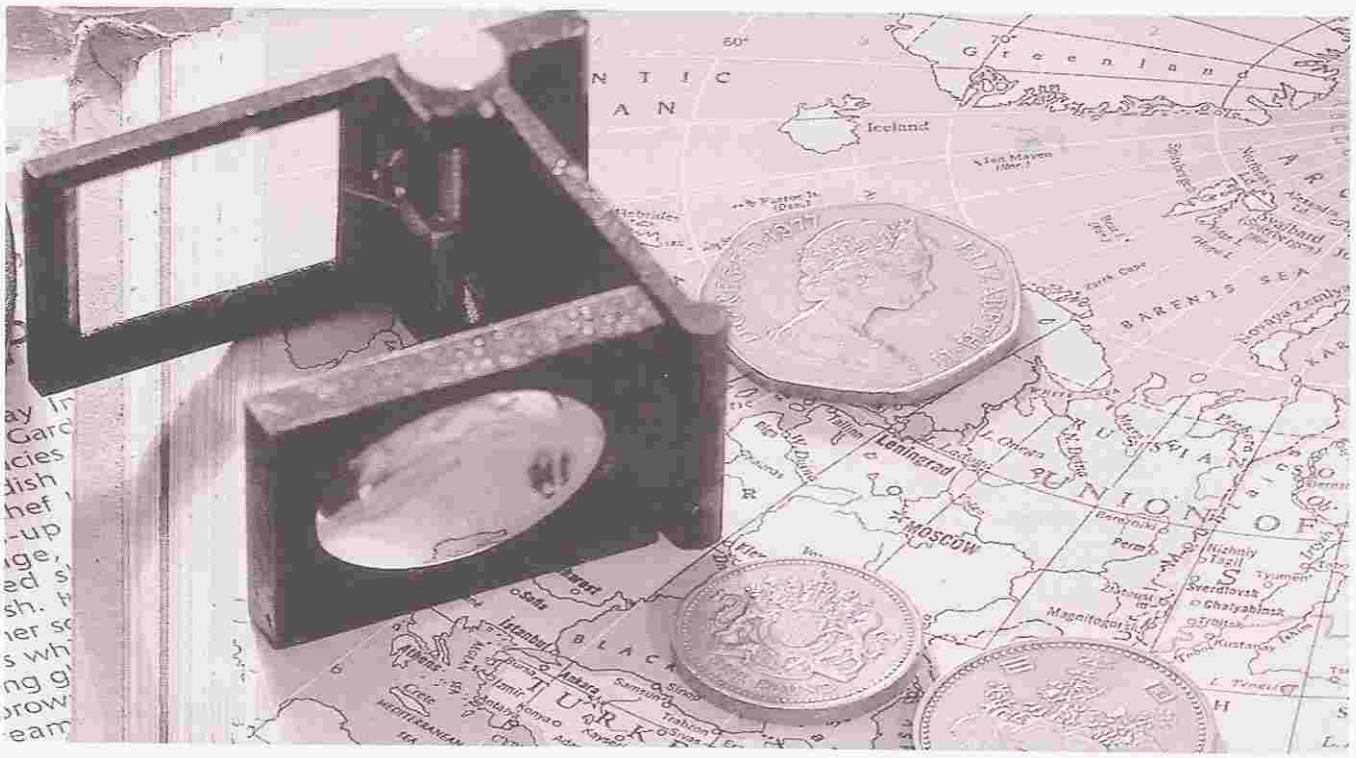


Most developed and developing countries have established FTZs where foreign and domestic goods can be stored, exhibited, repackaged, assembled or used for manufacturing free of customs duty, quota and other import restrictions.

If fraud is suspected, then Customs officers may carry out investigations and take the necessary action against these companies. The Minister may allow goods other than raw materials and machinery to be brought into a Free Industrial Zone for any activity subject to conditions. The Zone Authority has the power to order the exclusion or removal of any goods from a Free Industrial Zone or the discontinuance of any activity which are considered to be dangerous or prejudicial to the public interest, health or safety. Incidentally, after 1990, all Free Trade Zones became known as Free Industrial Zones.

One pertinent point to note is that goods which are specifically and absolutely prohibited under the Customs (Prohibition of Imports) Order 1998 and Customs (Prohibition of Exports) Order 1998 cannot be brought into a Free Zone. These are goods for import such as 'any article bearing the imprint or reproduction of a currency note, indecent or obscene items, daggers and flick knives etc. and goods for export such as turtle eggs, rattan (from Peninsular Malaysia) and certain poisonous chemicals. Goods consumed in a Free Zone are also given exemption, provided they are not removed for export to a country outside Malaysia. Goods destroyed require prior approval from the Zone Authority. The movement of goods from a Free Zone into the Principal Customs Area is considered as import and the movement of goods from the Principal Customs Area into the Free Zone is considered as export. Since 1st June 2003 other value-added activities such as research and development, design, marketing, distribution, quality control, testing, labeling and packing are allowed in a Free Zone in line with the government's effort to stimulate the economy. Now companies in the Free Zones are allowed to carry out these activities for other companies as well. Prior permission has to be obtained from Customs.

The Customs officers at the Free Zones are responsible for the movement of goods into or out of the Free Zones. All vehicles

or persons entering or leaving a Free Zone are required to declare the goods they are carrying. In certain cases the officers may search the vehicle, the person, his goods or baggage if they suspect that certain goods have not been declared. For commercial goods, proper Customs declaration forms should be filled in and submitted to Customs. As mentioned before only machinery, equipment and raw materials are given exemption. The rest of the goods are dutiable i.e. customs duties, sales tax and excise duties have to be paid.

Free Zones or Free Trade Zones as they are known in other parts of the world are an important part of international trade. Most developed and developing countries have established FTZs where foreign and domestic goods can be stored, exhibited, repackaged, assembled or used for manufacturing free of customs duty, quota and other import restrictions. Due to simplification of import and export procedures, delays relating to Customs clearances and duty drawback procedures are eliminated. Also cargo insurance rates have been reduced because the imported merchandise is shipped direct to the Free Zones. This results in considerable savings for the operators in the Free Zones. We can be optimistic that the Malaysian Government will establish more Free Zones in the future now that AFTA is in force and the aim is to reduce consumption of imported goods and concentrate more on exports.

From our discussion above, it is clear that companies willing to operate in a Free Zone must be export oriented. Other companies which export a small part of their production need not locate in a Free Zone but take advantage of other facilities and tax/duty exemptions provided by the Customs Department such as the Licenced Manufacturing Warehouse or exemptions given under sec. 14(2) of the *Customs Act 1967*. It is best to consult a tax consultant or a senior officer of Customs to obtain more information on the facilities and exemptions available.

The Author

Thomas Selva Doss

is a customs consultant in Dossnett Consulting Sdn. Bhd. a company providing customs advisory services to clients in Malaysia and Singapore. He was a Senior Officer of Customs in the Royal Malaysian Customs Department for 13 years and is trained in Customs Audit, Customs Investigation and Anti-smuggling procedures. He holds a Bachelor's degree in Economics and a Certificate in Customs Procedures from the Malaysian Customs Academy. He can be contacted at 012-2309417 or e-mail : customs@tm.net.my

Case Digest

Gains on Disposal of Land Taxable under Sec. 4(a) of ITA

THE TAXPAYER PURCHASED AGRICULTURAL LAND ON 29 APRIL 1979, WHICH WERE SUBDIVIDED FOR HOUSING AND COMMERCIAL PURPOSES AND DISPOSED OF SUBSEQUENTLY. IN THE TAXPAYER'S ACCOUNTS, THESE SUBJECT LOTS WERE CLASSIFIED UNDER FIXED ASSETS.

On 4 June 1980 when a portion of the land was sold, the taxpayer applied for a certificate of clearance under sec. 12(4)(b) of the *Real Property Gains Tax Act (RPGTA) 1976* claiming that it was a property dealing company and its gains from the disposal were chargeable under the income tax law. The gains were therefore so charged. The taxpayer ceased construction activities and development operations in 1987. The taxpayer then went into a "rescue plan" whereby the subject lots were rezoned to industrial land and petrol station to enhance their sales.

The Director-General raised assessments on the disposal of the lots under the RPGTA for the years of assessment 1991, 1993 and 1994 and subsequently under the *Income Tax Act (ITA) 1967* for the years of assessment 1995 and 1996. The Director-General then unilaterally issued Reduced Assessments on real property gains tax for the years of assessment 1991 and 1993. The taxpayer appealed against the said income tax assessments.

The taxpayer appealed to the Special Commissioner of Income Tax and raised the following issues :

a. whether the gains from the disposal of the subject lots were subject to income tax under the ITA or to real property gains tax under the RPGTA;

b. whether the Director-General had power under the RPGTA to unilaterally issue reduced assessments in respect of assessments raised under the RPGTA; and

c. whether the Director-General can maintain two assessments, one under the ITA and one under the RPGTA.

The Special Commissioner dismissed the appeal .

1. The gains from the disposal of the lots were taxable under sec. 4(a) of the ITA. Applying the badges of trade relevant to this case and considering the intention with which the taxpayer acquired the lots, the only inference to be drawn was that of "an adventure in the nature of trade". The taxpayer's Memorandum of Association also lent support to this inference.

2. The treatment of accounts in the Annual Audited Accounts was not a proper description of the actual nature of the transaction.

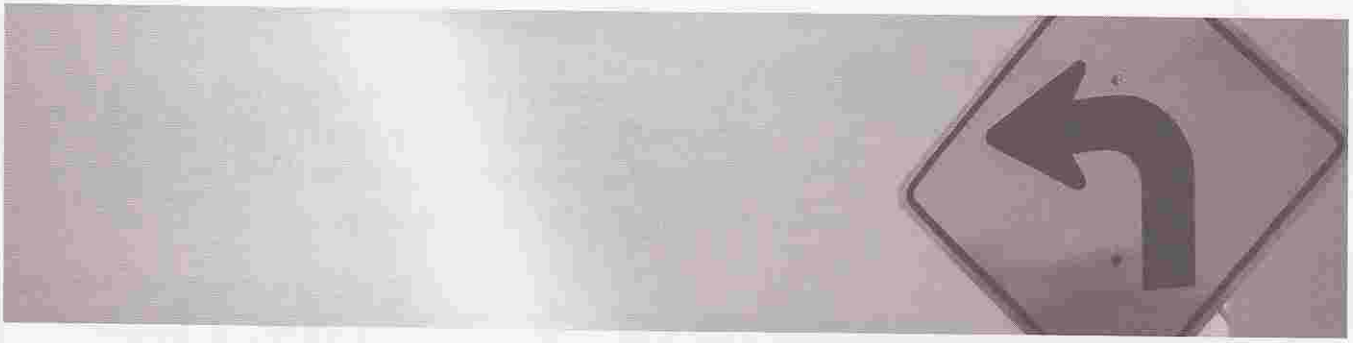
3. The taxpayer's contention that a forced sale vitiated the intention to trade was rejected.

4. On the second and third issues, the Revenue has the power to review or revise an assessment if the gains are found to be income in nature in which real property gains tax cannot be chargeable. Where assessment has been raised under the RPGTA and subsequently discovered that there was no chargeable gain, the Revenue must discharge the assessment.

5. The Respondent has power under the RPGTA to unilaterally issue reduced assessment in respect of assessment raised under the RPGTA. There is no double taxation or maintaining two assessments in this appeal.

AT Sdn. Bhd. v. Ketua Pengarah Hasil Dalam Negeri.
Special Commissioners of Income Tax.
Rayuan No. PKCP (R) 12/2000.
Judgment delivered on 29 March 2002.

Dr. Arjunan Subramaniam and Ms Chew Chung Huay (Advocates and Solicitors) for the taxpayer.
Y.M. Raja Kamarul Zaman bin Raja Musa and Encik Norhisham bin Ahmad, (Legal Officers, Inland Revenue Board) for the Revenue.
Before: Hariraman Palaya, Kamarudin bin Mohd. Noor, Dato Haji Ahmad Padzli bin Mohyiddin (Special Commissioners).



Tax Exempt Status For Body Corporate Established Under the Legal Profession Act ("the LPA")

THE TAXPAYER IS A BODY CORPORATE ESTABLISHED UNDER THE LEGAL PROFESSION ACT ("THE LPA") AND HAS BEEN GRANTED WITH A TAX EXEMPT STATUS BY THE MINISTER OF FINANCE EXCEPT FOR INCOME DERIVED FROM ITS COMPENSATION FUND, DIVIDEND INCOME AND DEVELOPMENT TAX.

Between 20 November 1986 to 5 October 1999, the taxpayer sought clarification of its tax exempt status from the Director General and the Minister of Finance. The Revenue informed the taxpayer that no assessment would be raised until the taxpayer's tax exempt status was clarified. The taxpayer then filed its returns on the basis that it was tax exempted and derived no chargeable income. Due to the time taken in determining the status of the taxpayer, the Director General raised assessments upon the taxpayer on the basis that it was a trade association deriving business income chargeable to tax for the years of assessment 1979 to 1991. Revenue expenses incurred in the production of its "gross income" were deducted. Capital allowances were, not granted as they were not claimed by the taxpayer at the time when it filed the returns.

The taxpayer objected to the assessment and appealed to the Special Commissioners of Income Tax on the following issues :

1. whether by reason of sec. 142 of the LPA, the taxpayer was liable to tax;
2. whether sec. 53 of the ITA was applicable to the taxpayer;
3. whether income derived from the Compensation Fund was chargeable to tax in the light of sec. 80(13) of the LPA; and
4. should the taxpayer be held to be a trade association.

The appeal was allowed by the Special Commissioner.

The tax exemption provision is also provided under sec. 142 of the LPA and not necessarily confined to sec 127 of the Act alone. As the LPA was legislated subsequent to the Act, the Parliament is presumed to know all the revenue law upon the particular subject upon which it legislates. If there was a doubt whether Legislature had intended to impair the rights of the taxpayer as envisaged under sec. 142(2) of the Act, the ambiguity must be construed in favour of the taxpayer. The acquired right of exemption from income tax under sec. 142 of the LPA therefore still subsisted.

When having enacted a general Act and the Legislature, subsequently makes a special provision in conflict with the earlier legislation, the special provision so in conflict with the earlier legislation, is treated as a mere exception to the general provision. Section 142(2) was therefore an exception to the Act.

On the second issue, to determine whether the taxpayer is a trade association, it was found that the requirements to be an association of persons were not satisfied. The taxpayer was created by statute. Its primary objective was to regulate the conduct of the legal profession and to uphold the cause of justice and not to produce income or profits. Therefore sec. 53 of the ITA was inapplicable.

With regard to the taxability of the income derived from the Compensation Fund, sec. 80(13) of the LPA was worded in the mandatory language and the Director General, had clearly failed to give effect to the intention and spirit of the Legislature.

On the last issue, the taxpayer's returns were made under sec. 78(a) of the ITA and therefore the period of limitation for the claim of capital allowances was inapplicable.

It was also objectionable for the Director General to argue that the taxpayer had waived its right to claim capital allowances when it failed to do so when it filed its returns, since the taxpayer was given legitimate expectation that it would be tax exempt. The taxpayer could not comply with the period of limitation for the claim of capital allowance due to the long lapse of time taken by the Director-General in reaching a decision as to the tax exempt status of the taxpayer. The taxpayer was therefore not barred from claiming capital allowance.

MB v. Ketua Pengarah Hasil Dalam Negeri.
Special Commissioners of Income Tax. Appeal No. PKCP (R) 22/1999.
Judgment delivered on 31 March 2003.

Nik Saghir bin Mohd Noor, Anand Raj and Irene Yong (Advocates and Solicitors) for the taxpayer.
Y M Raja Kamarul Zaman bin Raja Musa and Encik Norhisham bin Ahmad, (Legal Officers) for the Revenue.
Before: Hariraman Palaya, Haji Kamarudin bin Mohd. Noor, Dato Haji Ahmad Padzli bin Mohyiddin.

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

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Malaysian Institute Of Taxation

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Malaysian Institute Of Taxation

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TIME	20.12.2004	21.12.2004	22.12.2004	23.12.2004	24.12.2004
9.00 am to 12.10 pm*	Taxation I	Business & Financial Management	Financial Accounting II	Economics & Business Statistics	Financial Accounting I
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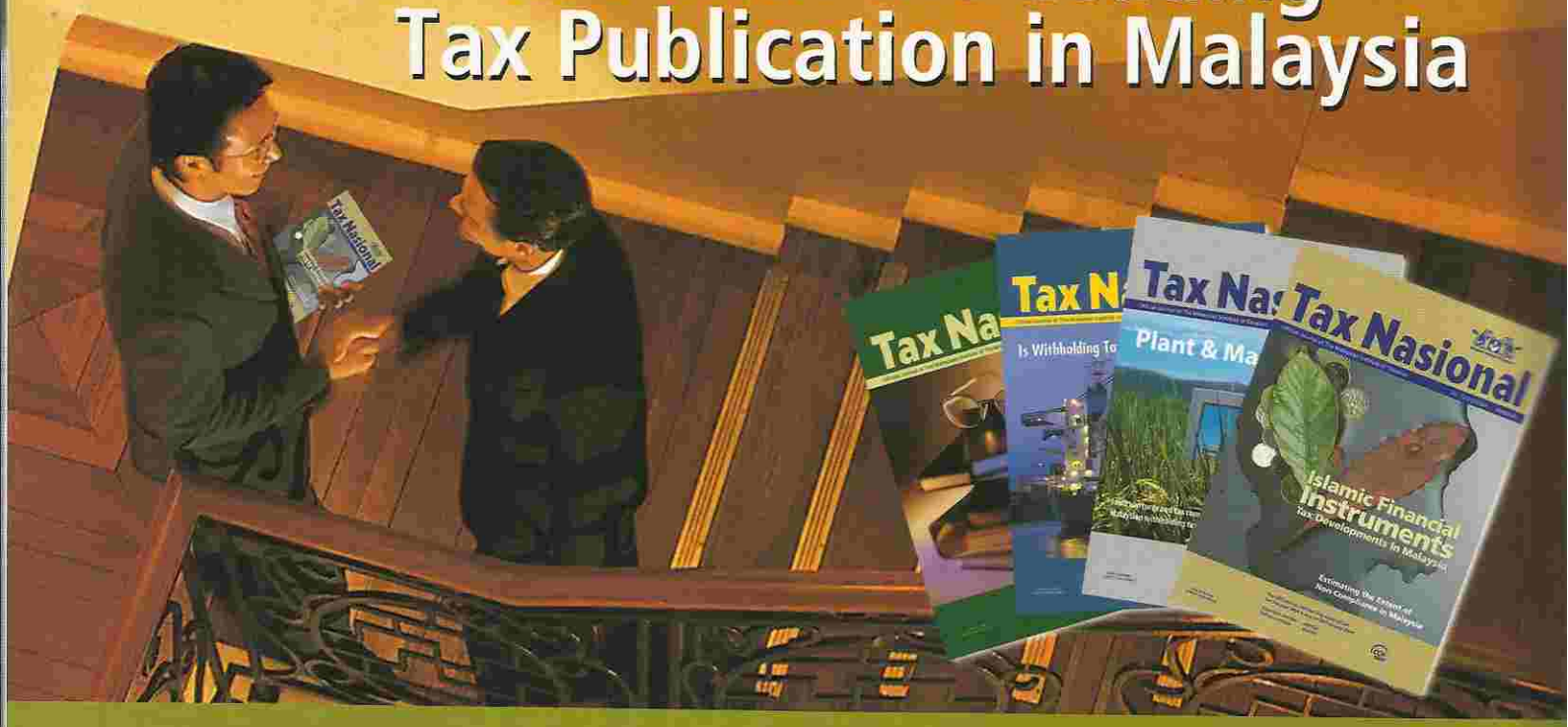

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