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TECHNICAL

Direct Taxation

TAX CASE UPDATE

Whether franchise fees received from overseas franchisees were income derived from source outside Malaysia? Whether consequential penalty imposed under Section 113(2) of the ITA is correct in law.

Kyros International Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri (2013) (CA)
(Civil Appeal No: B-01-16-2010)

Facts:

Kyros International Sdn. Bhd. (KISB) is in the business of operating kebab fast food chain and investment holding. It is the registered owner of the trade mark, KYROS, and granted the sole and exclusive right to the franchisee to establish and operate in a designated area. The operation of fast food chan activities was transferred to KYROS Kebab Sdn Bhd. In other words, there is a separation between the operations from the holding of rights and trademarks in the two separate entities.

KISB entered into franchise agreement with overseas franchisees. There are two types of franchise agreements, the Master Franchise Agreement and the Non-exclusive Unit Franchise Agreement. The former were subject to payments for *franchise fee, royalties* (consist of a sum equal to 5% of the turnover and a sum equivalent to 50% of the continuing monthly royalty) and *business development fees*. The latter were subject to payment for *franchise fee* and monthly *royalty* equal to 5% of the gross turnover. The franchise fees payable include the cost of initial technical and outlet training and other matters (if any).

It was asserted that the right granted has 2 distinct aspects, namely, the proprietary trade mark, KYROS, and the operating system of the appellant. Support for the franchisee is provided by sending KISB's staff to audit on the operating system, and advice on ways to improve operations and business development.

Issues

(1) whether payments received by KISB under the franchise agreement it entered with foreign entities are exempted under Paragraph 28, Schedule 6 of the ITA;

(2) whether the penalty imposed under Section 113(2) of the ITA is correct in law.

Decision:

Franchise Fees

The SCIT found as a fact that the "*"execution or operations of business by the foreign franchisees took place outside Malaysia",* and *"hold that all activities in respect of the agreements entered into with the foreign entities took place outside Malaysia.*". Relying on Privy Council case of *CIR v. Hang Seng Bank Ltd [1990]* STC 733, the SCIT held that all the activities in respect of the franchise agreement is akin to letting property as stated in that case and the franchise fees received from the foreign franchisees are income received "from the place where the property was let.". Hence, they are exempted of income tax under Paragraph

28, Schedule 6 of ITA and allowed appeal by KISB.

The High Court ruled that:

- From the facts established, it is clear that franchise fees excludes royalty, which is to be charged separately based on turnover. Hence, "the franchise fee is essentially for the purpose of the services rendered by the franchisor to the franchisee." KISB contention that the exploitation of trade mark was outside Malaysia was irrelevant as the franchise fees do not include exploitation of trade mark.
- The reliance placed by the SCIT on the fact that "…the execution or operation of business by the foreign franchisees took place outside" is irrelevant in determining whether the receipt of franchise fee is outside or within Malaysia. The fact that the operations of franchisees are abroad does not support the SCIT's findings that operation of KISB is abroad. KISB is in receipt of franchise fee from the franchisee and not income from the business of selling kebab.
- The proper consideration before the SCIT should be, whether the franchise owned, services and advice provided by KISB to the overseas franchisees under the franchise agreements, are indeed an operation outside Malaysia by KISB. The SCIT had misdirected itself in concluding that the operation of the franchisor was outside Malaysia on the basis that the operations of the franchisees were outside Malaysia.
- As decided in *ABC v Comptroller of Income Tax, Singapore (1959)* 1 MLJ 1963, the burden to show that the assessment was erroneous and what is right is always on the taxpayer. However, KISB failed to establish in evidence to show that the operation or activities of KISB in providing the services to the foreign franchisee is an operation outside Malaysia. The SCIT's findings made without any evidence is an error.
- An appellate court can intervene with the decision of the SCIT on the grounds of misconception of law, or conclusion of law which cannot be supported by the primary facts and conclusion of mixed fact and law that no reasonable SCIT could have reached if they had correctly directed themselves. Such principle is supported in the Court of Appeal decision in *Chua Lip Kong v Director General of Inland Revenue [1982] 1 MLJ 235* and in the Supreme Court decision in *Lower Perak Co-operative Housing Society Bhd v. KPHDN [1994] 3 CLJ 265.* Consequently, the appeal by IRB is allowed.

The Court of Appeal held that:

- "Appeal is a rehearing of a case." Where a court sits in its appellate jurisdiction and interferes in the finding of facts of a trier of facts, three things must appear from the judgment of the court:
  " (i) that the court has applied its mind to reasons given by the trier of facts
  (ii) that the court's cognisance that the trier of facts had the advantage of seeing and hearing the witnesses the benefit of which the appellate court do not have; and
  (iii) that the court must give cogent reasons for disagreeing with trier of facts."
- "It is not permissible for court exercising appellate jurisdiction to extract abstract statements from the submission of the parties without going through a process of full hearing as advocated in the Courts Judicature Act 1964, and stating in the grounds that there was "insufficient judicial appreciation" or the judge or tribunal "fell into error" etc."
- "Where the decision of the SCIT is appealed to the High Court by way of case stated, the burden lies on the appellant (in this case the IRB) to satisfy the court that the SCIT's decision was based on the misconception of the law or their conclusion cannot be supported by the primary facts and that conclusion on the mixed facts and law in this case was such that no reasonable Special Commissioners could have reached it if they had correctly directed themselves."

- It is well settled that the appellate court generally recognizes the special position of the SCIT. In Edwards v Bairstow & Harrison 36 TC 207, Lord Radcliffe has stated that "the reason why the Courts do not interfere with Commissioners' findings or determinations when they really do involve nothing but questions of fact is not any supposed advantage in the Commissioners of greater experience in matters of business or any other matters. The reason is simply that by the system that has been set up, the Commissioners are the first tribunal to try an appeal and in the interest of the efficient administration of justice, their decision can only be upset on appeal if they have been positively wrong in law. The Court is not a second opinion, where there is a reasonable ground for the first."
- In Chua Lip Kong v Director General of Inland Revenue [1982] 1 MLJ 235, the Privy Council held that "their Lordships cannot stress too strongly how important it is that, in every Case Stated for the opinion of the High Court, the Special Commissioners should state clearly and explicitly what are the findings of fact upon which their decision is based and not the evidence upon which those findings, so far as they consists of primary facts, are founded. They can be neither overruled nor supplemented by the High Court itself; occasionally they may be insufficient to enable the High Court to decide the question of law sought to be raised by the Case Stated, but in that event it will be necessary for the Case to be remitted to the Commissioners themselves for further findings."
- On the factual matrix of the instant case, the Court of Appeal agreed with learned counsel for KISB that the finding of facts of the SCIT does not warrant the appellate interference by the High Court and allowed the appeal of KISB.

Penalty

KISB relies on the case of Office Park Development v Ketua Pengarah Hasil Dalam Negeri [2011] 9 MLJ 479, where the High Court held that the SCIT were correct in their finding that the taxpayer's incorrect return was made in good faith and that the penalty imposed by the IRB in respect of the same should be waived. In that case, the Court indicated that "(the) IRB's contention that s.113(2) of the ITA did not provide the defence of good faith was without basis. The penalty provisions in ss113(1) and (2) of the ITA are to punish taxpayers who deliberately submit incorrect tax returns and information and it was not the intention of the Parliament to punish innocent taxpayers. Further, it was not mandatory for the IRB to impose a penalty in all tax audits."

The SCIT found that there was no non-disclosure of information on the accounts in the book of KISB and it had also given full disclosure during audit. The SCIT made its finding that KISB had not been recalcitrant and "had not made incorrect returns for all the tax years under appeal". The SCIT allowed KISB appeal on the imposition of penalty by the IRB.

The High Court held that:

It is clear that under s.113(2) of ITA, the discretion to impose penalty or otherwise is solely at the discretion of Revenue Department. In view of the fact that "franchise fee" is not given specific treatment under ITA, neither is there any guideline or direction issued by the IRB on the same, it is an appropriate situation for the DGIR to exercise his discretion in favour of the taxpayer. The appeal of the IRB should be dismissed.

The Court of Appeal takes the view that the learned judge (of the High Court) was right to sustain the decision of the Special Commissioners.