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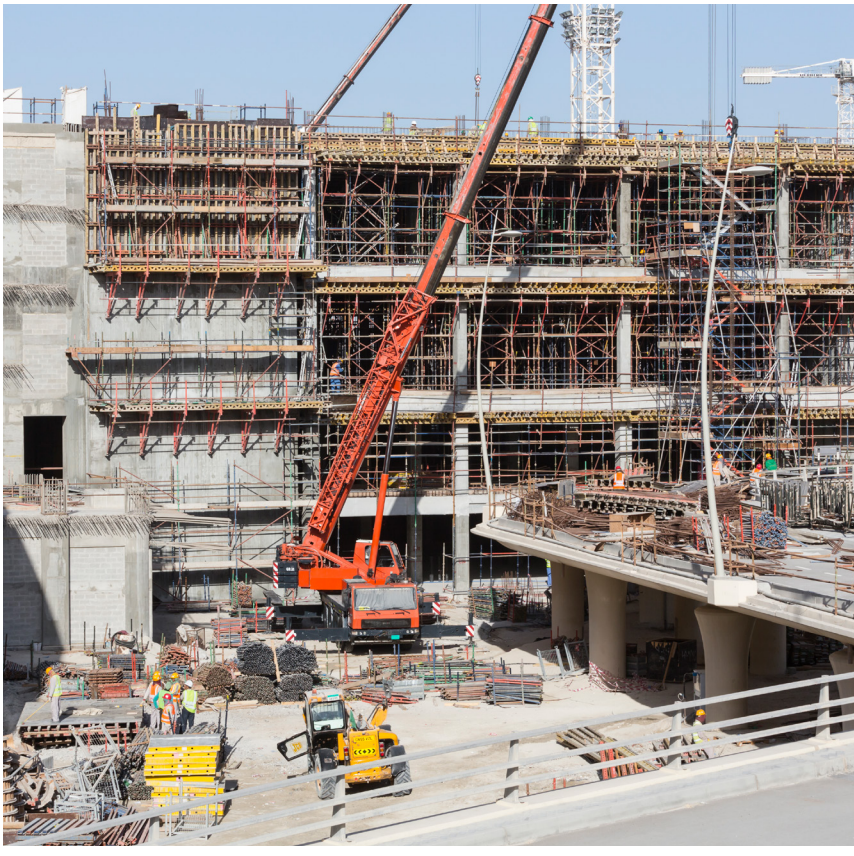
PwC Alert

Tax avoidance



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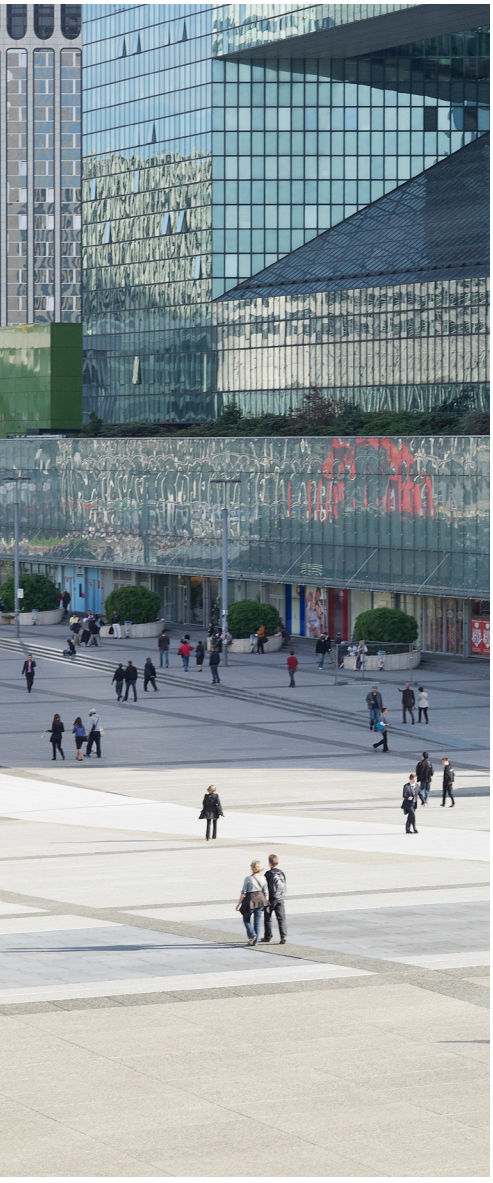
Of tax planning, avoidance and perils when you falter



Prior to 2010, there were only a handful of litigation cases on tax avoidance which was reflective of the Malaysian tax authorities' cautious approach in invoking the general anti-avoidance rules (the GAAR), Section 140 of the Income Tax Act (the Act). However, the spate of cases from 2010 onwards shows a paradigm shift, signalling that Section 140 is very much under the radar of the tax authorities.

The Court of Appeal recently delivered a landmark judgement in the case of *Syarikat Ibraco-Peremba Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* [Civil Appeal W-01-177-04/2013] (the Ibraco-Peremba case) which dealt with the application of Section 140 of the Act.

Section 140 - Power to disregard certain transactions

(1) The Director General, where he has reason to believe that any transaction has the direct or indirect 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 would otherwise have 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

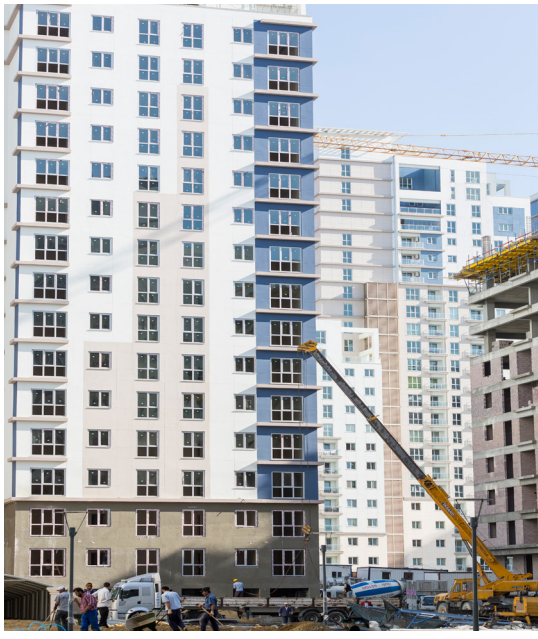
(d) hindering or preventing the operation of this Act in any respect,

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

The Ibraco-Peremba case

The taxpayer in this case, a property developer, purchased land in 1992 for long term investment purposes and built commercial properties to be leased out. Upon advice from its tax advisor, it undertook the following series of transactions.

	Year	Transaction
1.	1994	*The taxpayer sold the land to IPH, a newly incorporated subsidiary whose principal activity was investment holding and property development. IPH then entered into a turnkey construction contract with the taxpayer to develop the land. Upon completion of the development in 1996, IPH rented out the properties and treated the rental income as its business income.*
2.	2003	*The taxpayer sold its shares in IPH which is a real property company (RPC) to VSB, a related company, pursuant to a corporate restructuring exercise. (The taxpayer and VSB were controlled by the same shareholder.) No real property gains tax (RPGT) was payable as the disposal took place during the RPGT exemption period.*
3.	2003/2004	*IPH sold all the properties to third parties but no RPGT was payable as RPGT was exempted then. IPH was then voluntarily wound up and the assets of IPH including the sale proceeds of the properties were passed to VSB. VSB then repaid the taxpayer for the cost of the IPH shares. Subsequently VSB was wound up and its assets were distributed to its shareholders.*



The Director General of Inland Revenue (DGIR) contended that there was no commercial reason for setting up IPH except for the purpose of a scheme to avoid income tax being charged on the profits from disposal of the properties. As a result, the DGIR invoked Section 140 to disregard the transactions of the taxpayer and IPH and assessed the taxpayer on the total value of the disposal of properties net of development cost.

On appeal by the taxpayer against the DGIR's assessment, all levels of appeal agreed that Section 140 applied and the penalty for incorrect returns under Section 113(2) was correctly imposed. The courts found that the transactions were entered into through shell companies with the primary purpose of avoiding tax that would have been paid if the developed properties were sold by the taxpayer.

Key observations

The Ibraco-Peremba case stands out not only as it was decided by the Court of Appeal which makes the decision binding on the lower courts, but also it raises questions on the parameters of legitimate tax planning.

- ***Purpose of transaction***

  The scope of Section 140 is wide as it can potentially extend to transactions that have "a direct or indirect effect" rather than merely "a purpose" of "(a) altering the incidence of tax …, etc". However, as with other similar cases, the tax authorities in the Ibraco-Peremba case considered the purpose of the transactions and evaluated the genuineness or otherwise of the transactions.

  As established in the case of *WT Ramsay Ltd v Inland Revenue Commissioners [1981] 1 All E.R. 865*, where the scheme comprises a few steps or transactions, the genuineness or otherwise of the transactions should be looked at as a whole. The taxpayer in the Ibraco-Peremba case argued that the transactions entered into could not have been pre-ordained due to the long holding period of the properties prior to disposal by IPH. However the court did not think the argument was valid as the transactions when viewed as a whole, show that they were part of the relevant steps to discharge the scheme of avoiding tax by the taxpayer. The legitimacy of a tax avoidance scheme is to be examined in its entirety.

  This case serves as a useful reminder on the importance of being able to demonstrate that any transaction entered into is driven by commercial expediency and any tax benefit derived is purely incidental to counter any potential challenge of tax avoidance by the tax authorities.

- ***Penalty for incorrect return***

Section 140 provides that when the DGIR invokes the GAAR, he may disregard or vary the transaction and make appropriate adjustments to counter-act the tax benefit derived from the tax avoidance arrangement. In contrast to other jurisdictions such as Australia (which has specific anti-avoidance penalty provisions), Section 140 does not provide for the imposition of penalty on additional assessments raised as a result of making adjustments in tax avoidance cases. Following this observation, one view is that the DGIR has no authority to impose penalty for incorrect return in a tax avoidance case in the absence of a specific penalty provision within Section 140. However, the court in the Ibraco-Peremba case allowed the penalty imposed by DGIR to remain on the basis that the penalty provision under Section 113 (Incorrect returns) operates independently from Section 140. The Court of Appeal judge said:

> *"… Section 140 does not expressly nor impliedly exclude the operation of Section 113. Section 140 gives the discretion to the Respondent (the tax authorities) in certain circumstances …. Neither does the provision of Section 113 exclude its application in the circumstances provided for under Section 140."*

It is interesting to note from the reported case that the Court of Appeal decided not to intervene with the DGIR's decision to impose the penalty as the "scheme" would not have been discovered if not for the tax investigation. This raises a question on whether taxpayers are required to make a disclosure on any tax planning undertaken as the Act is silent on this requirement.

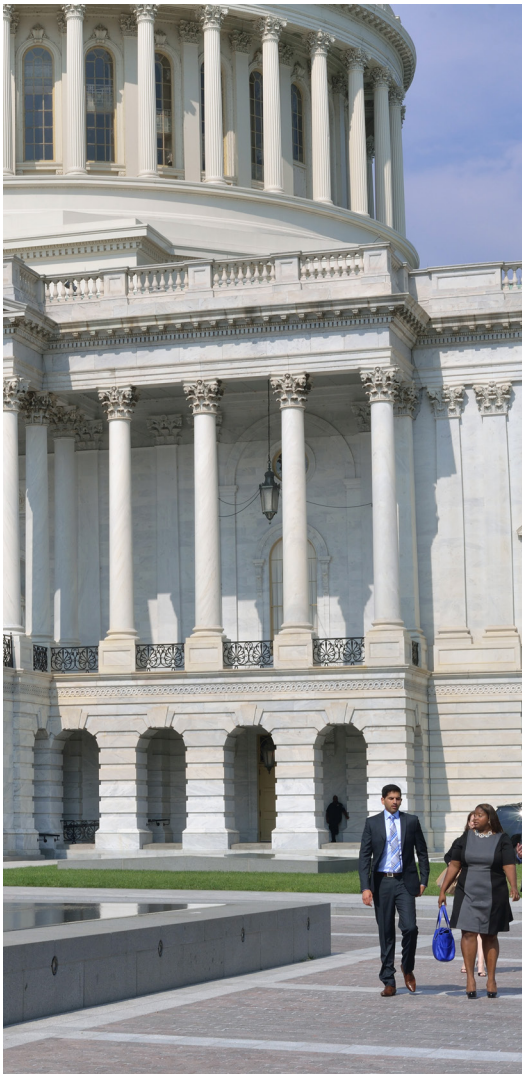
- ***Defence of "good faith"***

  The question of whether "good faith" is an acceptable line of defence against the imposition of penalty for incorrect return under Section 113(2) of the Act even though it is not specifically provided in law, had been deliberated by the courts in a number of cases. The courts in some cases before Ibraco-Peremba had held that the DGIR may exercise his discretion not to impose penalty under Section 113(2) if the taxpayer can demonstrate that he had acted in good faith. However we did not see this decision trend continue in the Ibraco-Peremba case where the court dismissed the defence of good faith as it is not specifically provided in Section 113(2).

The above decision appears to contradict the Supreme Court's decision in *Ketua Pengarah Hasil Dalam Negeri v Kim Thye & Co [1992] 4 CLJ 2079* (the Kim Thye case). The court in the Kim Thye case recognised that the DGIR has the discretion to impose penalty under Section 113(2) but such discretion cannot be exercised at his whim and fancy.

Although the Kim Thye case was considered in the Ibraco-Peremba case at SCIT, it was not mentioned at all by the Court of Appeal. It is however interesting to note that the High Court in *Ketua Pengarah Hasil Dalam Negeri v Kyros International Sdn Bhd (2013) MSTC 30055* made a point that the Kim Thye case is not an authority to suggest that defence of good faith applies to penalty imposed under Section 113(2) as the principle established by the case is whether a decision on penalty is appealable under the Act.

Although the courts have in the past accepted good faith as a defence, the position now seems to have changed.



Conclusion

With the Ibraco-Peremba case decided in the tax authorities' favour, one may want to ponder if the following famous quote from Lord Tomlin in *IRC v Duke of Westminster [1936] AC 1* is still true or partially true:

"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 …".

The determination of whether one has crossed the boundaries of tax avoidance would have to be made based on the facts and circumstances of each case. Although the Ibraco-Peremba case is indisputably important, the court's decision should not be seen as restricting the right of taxpayers to plan their affairs so long as tax savings are not the primary or sole purpose of the arrangement. The main motivation for the arrangement should as always, be commercially driven.

Let's talk

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