

CHAPTER 1

TAX AUDIT AND INVESTIGATION: BACKGROUND AND RATIONALE

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[¶1-000] Introduction

It is almost like something straight out of a Scorsese movie. It is early morning and you are reading the newspapers, sipping your coffee and still half-asleep. There is a knock and upon opening your door you see several well-dressed persons standing outside, smiling eagerly. A dark Pajero lurks ominously in the background. You vaguely hear one of the officers say something but all that your befuddled mind registers are three fateful words, "Inland Revenue Board". Your mind freezes, you are unable to move, you have difficulty breathing. Your worst nightmare has just come to pass—you are under investigation by the tax authorities!

This is a scenario that is repeated almost everyday throughout the country and if it is not for investigation purposes, it is for audit. The inevitability that is attached to death and taxes can be misleading, since tax can often be worse than death when it takes on the form of an investigation. The two enforcement measures of investigations and field audits have now become standard operating procedures for the Inland Revenue Board (IRB). But things were not always this frightening, it is a fresh phenomena, at least in the case of audits, arising from the recent introduction of the Self Assessment System. What was the practice previously?

[¶1-010] Tax filing prior to year 2001

While the IRB's approach to investigation has remained virtually unchanged since it was first implemented, major revisions to enforcement have taken place with effect from the watershed year of 2001, particularly in respect of the taxpayer's obligation towards the filing of income tax returns.

The process practiced then was the "Official Assessment" method where the form was issued to the taxpayer who would proceed to complete and submit the tax return to the Director General (DG) together with accounts, supporting documents, and income tax computation.

Following the receipt of the income tax return, the DG would examine it and if necessary, raise queries and ask for further details or documentary evidence of matters which the DG may be dissatisfied with. In turn, the taxpayer would respond in writing and often in the interests of a better explanation, through a visit to the tax office. This aspect of the IRB's verification was known as the "desk audit". Once contented with the reply, or in cases where the DG was not satisfied with the reply, the DG would issue a notice of assessment, invariably accompanied by a tax computation. Upon being served the notice of assessment, the taxpayer would settle whatever taxes still due or make arrangements to meet his payment responsibilities through instalments. This entire process from the issuance of the income tax return to the service of the notice of assessment constituted the "Official Assessment System".

However, the "then and now" differences are not just limited to the manner of raising assessments. Other aspects have also been reformed, though often just to the extent of "range and degree". The most obvious would be the matter of tax rates—from a previous maximum of an astounding 65%, the tax rates applicable to an individual have gradually fallen to a more amicable 27% (YA 2009 onwards). In addition, the reliefs a person would be entitled to have grown both in the types available and the amount each offered. A simple example would be the personal relief which from a previous RM2,500 has now swelled to RM8,000 and child relief, from a maximum of RM750 for the first child in the past to the present minimum of RM1,000 for each child.

New reliefs have also been introduced, like medical expenses for the taxpayer and his/her family or parents and medical and child education insurance. Another most welcome innovation are the personal rebates. Thus, the benefits currently provided encompass a relaxation of tax rates and the expansion of reliefs both in nature and quantum. In fact, it might be safe to hold that almost all the tax amendments over the last 25 years or so have been in favour of the taxpayer. That being said, the wary taxpayer may ask, "Where is the catch?" Surprisingly, there is NO catch, except perhaps the fact that the taxpayer may be caught by a field audit or an investigation!

MAJOR DEVELOPMENTS IN THE MALAYSIAN TAX SYSTEM

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[¶1-020] Major developments in the Malaysian tax system

The various extensions to tax benefits and reliefs mentioned above cannot be directly attributed to the present predilection of the IRB carrying out a more vigilant and thorough enforcement program. Nevertheless, together with other principal features introduced in the last few years, the extensions to tax benefits and reliefs have contributed to the revolution in tax rationale, philosophy, and administration. The IRB expects, quite fairly perhaps, that taxpayers reciprocate the relaxation now available to them through better and correct compliance.

[¶1-022] The waiver year: 1999

The year 1999 could be described as a windfall year for taxpayers because the waiver gift led to all taxes due for year of assessment 2000 (preceding year) being waived from payment. All the usual responsibilities relating to submission of income tax returns were still demanded of taxpayers but at the final stage of assessment, any tax payable was not required to be paid.

This totally unexpected concession was actually a precursor to another major change that came into effect from year 2000. On a more negative note, the waiver year returns caused selected persons to fall into the net of enforcement scrutiny, as will be explained later.

[¶1-024] Basis of assessment

The tax regime in Malaysia had traditionally followed the "preceding year" basis where the tax for a particular year of assessment was based on the income and circumstances of the previous year. Thus, the year 1995 formed the basis year for the year of assessment 1996 and so on. However, the Government decided that switching to the "current year" basis would be a more beneficial foundation to both the taxpaying community and the Government. This would be especially true when it comes to the question of payment of tax as the obligation would arise "immediately" and be tied to

the earning of the current year income rather than only in the following year. The delayed liability had often led to problems in payment and collection as the taxpayer's ability to settle the taxes due could have been impaired through a decline in business or level of income.

Accordingly, the change in basis year to the current year was implemented with effect from year 2000. Under this new approach, the income earned in year 2000 would form the basis for year of assessment 2000 (current year) and similarly for the following years. However, this would have meant that without any appropriate relaxation, taxpayers would have had to pay taxes for two years of assessment in year 2000; the tax on the 1999 income in accordance with the preceding year basis and the tax on the 2000 income following the current year basis.

To spare taxpayers this undoubtedly heavy double burden, a simple but bold solution was adopted—the tax on the 1999 income was waived! This did not lead to any fall or cessation in the collection of tax since the current year basis also demanded that taxes be paid in advance of the assessment. Taxes continued to be paid in year 2000, but the difference was that such payments accounted for year of assessment 2000 (current year) instead of for year of assessment 2000 (preceding year).

One definitely unwelcome but natural outcome of the waiver year was that some of the more imaginative taxpayers decided that they had come onto a good thing and thus arranged matters in such a way so as to transfer income correctly attributable to 1998 or 2000 to 1999 instead, thus being spared payment through the waiver. However, they had not accounted for the IRB's alertness towards this possibility! By the simple expedient of monitoring undue spikes in the 1999 income and comparing it to the levels in 1998 or 2000, the IRB quite effectively identified those who had attempted this artful dodge. This was achieved through the aid of the IRB's database and comparative analysis, leading to such persons being brought under closer examination. Adjustments were then made to both income and expenditure in the relevant years and the "correct" income was determined. For their pains, many taxpayers had additional assessments raised on them. With penalties!

¶1-026] Self assessment system

It could be said that the previous changes to the tax regime culminated in the revision introduced in 2001—the self assessment system! In its essence, the taxpayers merely pay, self assess, and submit, though obviously the actual implementation was far more complex than this summary suggests.

In the first phase of the progression towards self-assessment, only companies were involved and later in year 2004, this system was extended to individuals.

The principal features of the new system are as follows:

- Payment of tax is required to be made in advance through instalments — in the case of companies monthly from the second month of the basis period and for individuals, bimonthly from March of each relevant year. Individual employees continue to fall under the Schedular Tax Deduction Scheme.

- The submission deadline of the tax return is within seven months of the close of accounts for companies and for individuals the submission deadline is by 30 April if they have no business sources and 30 June where the individuals operate a business.
- No documents, such as accounts, receipts, or even tax computations need to be submitted to the DG. The tax return has been redesigned in such a way to comprehensively furnish all the particulars and other information the IRB deems necessary to verify the accuracy and correctness of the forms submitted. The only exception is when the taxpayer is entitled to a repayment of tax, whereby the taxpayer then has to send in the relevant dividend vouchers.
- Nevertheless, the taxpayer has the responsibility and duty to maintain sufficient records to enable the DG to carry out monitoring programs. Such records include source documents, records, accounts, income tax computations together with supporting schedules and worksheets. These documents and records would form the primary material for examination should the taxpayer fall under any tax audit or investigation.

Related developments

The 2009 Budget introduced sec 77B to the *Income Tax Act 1967*, which takes effect from YA 2009 onwards. Under sec 77B, taxpayers are allowed to self-amend their tax return. Thus the provision under sec 77B has some bearing on tax audits and investigations. This new feature is in keeping with the philosophy of the self assessment system, which demands that the taxpayer be responsible for the whole spectrum ranging from payment of tax to making necessary revisions in cases where he/she discovers an understatement of tax chargeable in a return submitted. However, sec 77B must not be confused with sec 131 where a taxpayer is permitted to make an amendment on the grounds that due to some error or mistake, he/she has submitted a return resulting in an assessment in excess of what he/she rightly should have been liable to. Under sec 77B, the taxpayer is effectively carrying out a tax audit on him/herself and further, is imposing the penalty due for the understatement.

Under this provision, a person who wishes to make an amended return must use a prescribed form; no doubt the Director General will introduce such a form, which can be expected to be simpler than the normal return form since it would relate to the understated income and undercharged tax only.

The following example illustrates the impact under the new provision:

Forgetmenot Sdn Bhd maintains accounts to 31 December. The company's return form for YA 2009 was submitted on 10 June 2010. The company later discovers that the income and tax it submitted was less than the due amount and thus wishes to make an amended return under sec 77B.

The amended return can only be made after 31 July 2010 (the due date for furnishing the tax return for YA 2009) and before 31 January 2011 (within six months of the due date). However, if the company submits an amended return by the 31 July 2010, that tax return would be recognised as the valid return for YA 2009 and the earlier return would be disregarded. The question of understatement of income and tax should therefore not arise.

If the amended return is submitted more than six months after the due date, it would no longer represent an amended return but a form submitted under voluntary disclosure, and the concessionary penalties would be applicable. The amendment of a tax return under sec 77B can only be made once for each year of assessment.

What should Forgetmenot Sdn Bhd do if following the furnishing of an amended return, it discovers another instance of understatement of income and tax? The second or subsequent furnishing of an amended return, whether by or after six months of the due date would fall under voluntary disclosure. Similarly, any furnishing of an amended return after six months of the due date would be a voluntary disclosure.

As a result of subsection 77B(6)(b), where the Director General has raised an assessment under sec 91 for any of the reasons stated therein, the submission of an amended return would not arise and the declaration of any understatement of income and tax would fall under voluntary disclosure. It must be remembered that the 10% or "formula" penalties, must be included in the computation of taxes due following the furnishing of an amended return.

The treatment of taxes due from an amended return are governed by an addition to sec 103(1A). From the subsection, it can be noted that a late payment increase will not always arise immediately upon an amended return being furnished. The person is allowed a period of sixty days after the due date, and only if any amount remains outstanding would the 5% increase be imposed. However, if the amended return is furnished after sixty days (and within six months) of the due date, the 5% increase will apply even if the tax is paid with the return.

¶1-100 Rationale for tax audit and tax investigation

The enforcement action by the IRB could be described as a natural and necessary outcome of the introduction of the self assessment system, influenced by the following factors.

- Experience had showed that with taxpayers becoming increasingly aware of their responsibilities, the quality of tax returns submitted had increased considerably. Thus, spending time on tax returns that were invariably found to be fully compliant and acceptable was a waste of time and effort—an action that was not in any way productive.
- Under the self assessment system, there is ideally minimum intervention by the IRB in the entire process of submission of tax returns to the determination of chargeability being completely executed by the taxpayer.
- However, if this philosophy of "no intervention" was practised to the absolute, it was highly likely that many taxpayers would choose to deviate from their responsibilities and understate their income, as they would be encouraged by the knowledge that the IRB would not carry out any verification measures. A case in point is how some persons utilised what they misconstrued to be the possibilities in the waiver year!

Thus, tax audits are indispensable, in fact it could even be said that the IRB had no choice—tax audits had to be implemented!

¶1-120 What is tax audit and tax investigation?

Before proceeding to the difference between tax audit and tax investigation, it is important to understand the meaning of tax audit. The IRB issued the "Tax Audit Framework" (see ¶8-800) and "Tax Investigation Framework" (see ¶13-800) which are effective from 1 January 2007.

Tax audit

The "Tax Audit Framework" explains that tax audit is an examination of a taxpayer's business records and financial affairs to ascertain that the amount of tax that should be reported and paid are in accordance with the tax laws and regulations. Tax audit takes two forms, namely desk audit and field audit. See ¶8-100 for more on desk audit and field audit.

Desk audit will focus on straightforward issues that are normally dealt with via correspondence with the taxpayer. A field audit takes place at a taxpayer's premises and involves the examination of the taxpayer's business records.

Tax investigation

Tax investigation as described in the "Tax Investigation Framework" is an examination of a taxpayer's business and/or individual books, records and documents. The examination is to ensure that the correct amount of income has been reported and tax thereon paid in accordance with the tax laws and provisions. An investigation will only be carried out in cases where it is suspected based on precise and definite evidence that the taxpayer is deliberately trying to avoid paying tax or has committed an act of wilful evasion of tax. There are two categories of tax investigation, namely civil tax investigation and criminal tax investigation.

Civil tax investigation involves the detection of tax evasion (see also ¶13-010). Its primary concern is the recovery of tax loss and possible imposition of heavy penalties. Criminal investigation, on the other hand, is focused on gathering admissible evidence with a view towards prosecution and conviction of the tax evader for commission of offences pursuant to *Income Tax Act 1967 (ITA)*, *Penal Code (Act 574)*, *Criminal Procedure Code (Act 593)*, *Evidence Act 1950 (Act 56)* and other relevant acts. The functions and work procedures of both categories of investigation are similar.

¶1-140 Difference between tax audit and tax investigation

Investigations have always been practised by the IRB while tax audits are the new kids on the block. Both relate to the verification of returns made by taxpayers with the possible result of additional assessments and the imposition of penalties. While on the surface these two enforcement measures look similar, there are material differences between the two approaches, which could be summarised as follows:

- (a) The most obvious difference is that while notice is given to taxpayers of an impending audit, investigation strikes **without warning**. The basic reason for this is that should notice be given to a taxpayer that he/she would soon be subject to an

- (ii) A transcript or document certified by the Director General shall be admissible in court.
- (iii) Any document or communication relating to receipts, payments, or income between a person and another person whether an advocate, solicitor or such person shall not be privileged from disclosure to a court, the Special Commissioners, or the Director General.

¶1-320 Tax audit and tax investigation frameworks

Apart from the above provisions in the ITA, the DG has issued the "Tax Audit Framework" (see ¶8-800) and the "Tax Investigation Framework" (see ¶13-800). These guides outline the "rights and responsibilities of an investigation officer, the taxpayer and the tax agent in respect of a tax investigation or tax audit". The frameworks also provide insight into the manner in which the DG carries out his duties and how the taxpayer should respond.

¶1-328 Regulations on property development and construction contracts

Due to the characteristics of the business activities of property development and construction businesses, special tax treatment is applied to the computation of gross income and adjusted income. The methods adopted in recognising profits, treatment of disbursements, etc, are very often subject to the IRB's queries. On 23 August 2007, two Regulations on property development and construction contracts were gazetted, ie:

- Income Tax (Property Development) Regulations 2007; and
- Income Tax (Construction Contracts) Regulations 2007.

Both Regulations are deemed to have effect from the year of assessment 2006 and subsequent years of assessment. Although these Regulations are not directly related to tax audit and investigation, they require special mention as the Regulations provide certainty for tax treatment in respect of the computation of gross income and adjusted income from the property development and construction businesses.

The IRB has issued Public Rulings No 1/2009 'Property Development' and No 2/2009 'Construction Contracts' on 22 May 2009 to provide guidance on determination of gross income for computing adjusted income for the business of property development and construction contract. With the issuance of these 2009 Public Rulings, Public Ruling No 3/2006 dated 13 March 2006 is superceded. The need to issue Regulations in respect of construction contracts and property development could be that these two activities are complex matters for which different approaches are possible. Thus, the Regulations were issued to standardise the treatment of the activities and to avoid confusion regarding the IRB's requirements response.

These 2007 Regulations provide for the treatment of the following:

- recognition of income;
- circumstances for revision of estimated gross income;
- tax treatment on loss project;
- profit or loss determination at project completion;
- deductibility of expenses incurred during the defect liability or warranty period, etc.

CHAPTER 2

TAX AUDIT: FRAMEWORK AND PROCEDURE

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[¶8-010] The risk of being audited

Malaysia's self assessment tax system depends on voluntary compliance with the income tax laws. Therefore, it is important that the Inland Revenue Board (IRB) audit tax returns effectively and put the general fear in all taxpayers of being audited to encourage voluntary compliance with the income tax laws.

Percentage wise, the IRB can only audit very few tax returns. The IRB tax audits are often prompted by large business losses over a period of several years, raising the question of how the owner made a living during that time. Large tax deductions for travel, entertainment and automobile expenses that do not appear to relate to the company's sales volume also can trigger an IRB tax audit.

Generally, tax returns singled out by the IRB for audit would contain either tax deductions that appear too high in relation to the person's income, tax items that are erroneous, tax items that require proof or an explanation, or those that are on the IRB's list of hot tax issues.

Although the IRB's criteria in selecting a taxpayer to be audited may change with time, some tax areas are consistently high-risk. The chances for an IRB audit are higher depending upon certain types of income, certain amounts of income, profession, the types of transactions and the types of tax deductions claimed in the tax return.

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[¶8-050] Selection of cases for audit

The IRB selects cases for audit based on:

- risk analysis via a computerised system;
- information received from third parties;
- specific industries;
- specific issues faced by a certain group of taxpayers; and
- location, etc.

Some of the more common audit selection trigger factors are discussed in ¶1-200. In this section, we look more closely at several high-risk tax areas that may increase a taxpayer's probability of being audited.

¶8-010**[¶8-052] High wages**

Generally, the chances of being selected for audit by the IRB are higher as income increases. The chances of being audited by the IRB are greater under the following circumstances:

- there are complex investment or business expenses in your tax return;
- you own or work in a business which receives cash and/or tips in the ordinary course of business;
- your business expenses are large in relation to your income in your tax return;
- you have rental expenses in your tax return;
- a prior IRB audit resulted in a tax deficiency;
- you are a shareholder or partner in an audited partnership or corporation;
- you claim large cash contributions to charities in relation to your income in your tax return; and/or
- an informant has given information to the IRB.

[¶8-056] Unreported taxable income

Unreported taxable income is a common red flag. The IRB discovers unreported taxable income when its computers match the taxable income that you have reported in your tax return with information gathered from banks and others. For example, if you failed to report in your tax return the interest earned on your fixed deposit account, the IRB typically will catch you when it matches the bank's interest payment records against your tax return.

One good way to make sure that you do not miss unreported taxable income is to review the previous year's tax return to see whether you have receipts from mutual funds, banks and other sources.

[¶8-058] Self employment

Because the IRB believes most under-reporting of taxable income and abuse of tax deductions occur among those who are self employed, these individuals are audited by the IRB far more frequently than employees collecting a salary. The same may apply to taxi drivers, waiters and waitresses, and others who traditionally receive payments in cash. Also, the IRB will sometimes conduct tests on certain individuals to determine if a taxpayer's reported taxable income can support the taxpayer's lifestyle.

[¶8-062] Weighing the risk

You should make every entitled tax deduction in your tax return, and you should not be put off by the potentiality of an IRB tax audit. However, you must exercise common sense and weigh the risk that you are taking by claiming or using certain tax deductions in your tax return with the reward that you receive in terms of tax savings.

Taxpayers should not be frightened by possibility of an IRB tax audit since it is slight, but they should also not randomly increase their chances for an IRB tax audit with

items that have minimal tax benefit. Use your own judgment and common sense along with the advice of your tax professionals.

The best way to avoid a tax audit is to file a complete and accurate tax return. Double check your math, and make sure you have used the correct IRB tax forms and IRB tax schedules.

¶8-070 Other related developments

The 2009 Budget has introduced some amendments to sch 7A, which governs the claim for reinvestment allowance.

In summary, the amendments to reinvestment allowances are as below:

- The previous condition for a business to have been in operation for at least 12 months has now been extended to 36 months. This is a three-fold increase in the qualifying period. (Para 1A and 1C sch 7A)
- Where an asset upon which reinvestment allowance had been granted to a company is subsequently acquired by a "related" person, the acquirer will not be eligible to claim reinvestment allowance on that asset. This means that within a group of related companies, reinvestment allowance on a particular asset can be claimed only once. (Para 1B sch 7A)
- In the past, where an asset on which reinvestment allowance had been given is disposed of within two years from the date of acquisition, the allowance given will be deemed to have been not given. The effect is that the allowance is withdrawn. This period of two years is now being extended to five years. (Para 2A sch 7A)
- A somewhat detailed definition of "manufacturing" is now introduced. While the greater clarity is welcome, this new specific definition also serves to exclude activities that previously could have been construed to be acceptable. Thus from the very start, some projects would no longer qualify. (Para 9 sch 7A)

Schedule 7A was introduced to offer certain benefits and incentives to persons who had incurred capital expenditure on a factory, plant, or machinery for the purposes of a qualifying project. Of course some conditions were attached to qualify for the reinvestment allowance claim and the general effect was that 60% of the qualifying expenditure could be offset against up to 70% of statutory income, and such offset would constitute income exempt from tax.

However, amendments to sch 7A have restricted the benefits enjoyed by taxpayers claiming reinvestment allowance. While the reasons behind the new limitations are not known, they could be due to two possibilities — firstly, that the IRB intends that only serious long-operating persons enjoy the allowance and secondly, to ensure that opportunities for abuse are removed.

With the fresh focus on reinvestment allowance, it is only to be expected that this subject will be closely examined should the person come under a tax audit or investigation.

Law: sch 7A

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¶8-100 Types of tax audits

There are two different types of tax audits, ie desk audit and field audit. The type of audit faced makes an important difference in how the taxpayer should respond, what types of questions to expect and even whether or not the taxpayer should retain legal counsel or other professional assistance.

¶8-105 Desk audit

This is a relatively simple procedure in which the IRB asks the taxpayer to document an item in the taxpayer's return by a specified date. This is usually a routine test for compliance with certain items in the tax return. The taxpayer will have to dig out the receipts or other documents, make a photocopy for the IRB and mail it in with a copy of the audit request.

However, the IRB may also ask the taxpayer to report to a nearby IRB office and document one or more items in the tax return.

A desk audit is usually an easy process unless discrepancies or errors prompt the IRB to dig deeper into the tax return.

¶8-110 Field audit

This is the audit most people dread. The IRB will ask the taxpayer to provide documentation of various items in the tax return and to meet with an IRB officer for a thorough review of the taxpayer's records. A request for postponement can be made, so be sure to ask for one if you need time to gather the necessary documents (see item 7.2.2 of "Tax Audit Framework", ¶8-800).

If there are reasonable grounds, you may also reschedule the venue of the field audit (see item 7.1.2 "Tax Audit Framework", ¶8-800). Choose a neutral location—preferably at your tax agent's, since they probably know more about tax matters and tax laws than you do, and they can provide the best possible assistance. A neutral site also prevents the IRB officer from prejudging your income level based on a first impression of your home or office—an impression that is generally not to your advantage.

Before the meeting, gather the requested documents, organise them neatly and review your return to substantiate each item in question. Bring along all requested documents, such as bank statements, cancelled cheques, receipts, business logs and the calculations used to arrive at your figures, to the meeting. Presenting yourself as thorough and organised can help improve your credibility. Be prepared to answer the IRB's questions, but do not volunteer information. You can ask your tax agent or lawyer to speak on your behalf if you wish. Whatever you do, do not lie—if you do, you could face criminal charges.

If you are suspected of tax evasion, the IRB will conduct a tax investigation. If they prove that you have deliberately understated your income, you can face substantial fines and even jail time. Obviously, if this happens, you should retain qualified legal counsel.

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¶8-150 Preparing for a tax audit

Preparing for an audit is like preparing for a test in school; the IRB will inform the taxpayer of the sections of the tax return the IRB wants to examine so that the taxpayer knows what to "study". The first decision the taxpayer has to face upon receiving an audit notice is whether to handle the audit personally or to be represented by a tax agent. The taxpayer can request for the tax agent to be present during an interview. If the tax notice concerns the tax payer's entitlement to a tax deduction or questions a tax position taken in the tax return, it is advisable to consult the tax agent before responding to the IRB.

A satisfactory explanation can end the matter quickly. In any event, it is important to respond to the IRB in writing.

¶8-155 Types of documents and records to be prepared

Understanding what the IRB officer (ie the audit officer) might look for can make the difference between a minor inconvenience and a major hardship.

During a full-fledged audit, the audit officer may look at several specific items in the tax return and company records, including:

- income

The audit officer will compare the bank statements and deposits to the income the taxpayer reported. The audit officer will also review invoices, sales records and receipts, along with general ledger and other formal bookkeeping records. If a taxpayer received gifts of money or an inheritance, it is advisable to keep records to document the amount received. Without proof, the IRB may classify these as income and tax them as such. They will also classify any exchange of goods or services in lieu of cash (such as barter transactions) as taxable income.

- expenses and deductions

An audit officer may compare cancelled cheques, bank statements, credit card statements, receipts for payment or charitable gifts, and other business records to the expenses and deductions the taxpayer reported in the tax return. They may pay special attention to reported debts or business losses, charitable gifts, and travel, meal and entertainment expenses. Keep a log to substantiate travel, meal and entertainment expenses, and be sure to deduct only legitimate business expenses.

- loans and interest

An auditor may review loan paperwork, deposits, bank statements, credit card statements, receipts and cancelled cheques to verify that the taxpayer used borrowed money only to cover business expenses. This is important since the taxpayer may deduct interest on business related loans.

- payroll

Audit officers will examine cancelled cheques, tax returns, deposits, business records and other forms to check for completeness, accuracy and timely filing. They will also review income tax, employees' provident fund contributions and medical benefits. The IRB will also examine salaries and bonuses paid to owners/directors and officers of the taxpayer's business to ensure that they are legitimate and within industry standards.

- other records

The audit officer can also inspect records from the tax agent or accountant, bank or other financial institution, suppliers and customers.

For business owners, in addition to inspecting the business, an audit officer may inspect the owners' personal finances. The IRB may compare the current lifestyle with the income presented in the tax return to determine if they are compatible. An audit officer may also talk to others who are knowledgeable about the taxpayer and the financial situation.

¶8-160 Document claims and be organised

If the taxpayer decides to handle the audit personally, it is advisable not to wait until the last minute to gather receipts and other documentation. One of the risks is, for example, that certain documents could not be found.

The taxpayer need to document and be ready to speak with the audit officer only about those areas the audit notice stated were being investigated. Organise the various documents and receipts in folders. Taxpayers should make it as easy as possible for the audit officer to review the materials. A situation where the taxpayer simply shows up, dumps folders and dockets full of receipts and paperwork on the audit officer's desk and says, "Here it is, *you* figure it out," will not be helpful in an audit.

Do not bring documentation for parts of the return that are not being audited, either. The taxpayer is required to discuss only those areas mentioned in the audit notice.

Taxpayers are advised not to ignore the audit request letter. The IRB is the ultimate bill collection agency. And if the taxpayer ends up owing more money (the unhappy result of most audits), it is best to settle the outstanding amount within the time frame to avoid incurring penalties.

In most cases, the IRB tax notice will indicate the area of which the tax return is being questioned. Follow these guidelines to prepare for a face-to-face IRB tax audit:

- bring all the documentation relevant to the tax item(s) in question so that the evidence needed to support your tax case is available. Bring documentation only for tax items specified in the IRB tax audit notice;
- organise the papers according to the tax items in question and make copies of them;

- bring relevant worksheets to show how the tax figures in question were calculated; and
- at the IRB tax audit, do not volunteer tax information not requested by the IRB. Be cordial, but remember, "loose lips sink ships".

¶8-165] Do's and don'ts during the audit

Two people with identical situations can walk into an audit and come out with very different results. The loser can end up owing much more in taxes and have the audit expanded to include other parts of the return. The winner can end up owing less tax money. Here is how to be a winner:

- *treat the audit officer as a human being*

Believe it or not, most auditors are decent people just trying to do their jobs. They are well aware that taxpayers do not like seeing them. But taxpayers do not have to bow before them, either—just relax and behave as normal.

- *do not digress from the issues*

Taxpayers are there to discuss *only* the sections of the tax return in question. Unnecessary discussion into other areas might cause the auditor to probe into other items.

- *do not argue when you disagree*

If the audit officer wants to disallow a deduction or otherwise increase the tax owed and the taxpayer does not agree, the taxpayer should state only once the reason for disagreement. If the audit officer remains adamant, do not get into a knockdown drag-out confrontation. The audit officer may not want to lose face and is inclined to find additional tax money, which is the audit officer's job. Remember that, when necessary, taxpayers can plead their cases with several layers of people above the audit officer. If this method fails and the taxpayer still feels wronged, the taxpayer can take the case to the Special Commissioners.

- *do not be intimidated*

Most audit officers are not tax geniuses. The work is stressful—being in a job where people dislike seeing you is not easy. The taxpayer may not be at such a disadvantage in tax knowledge after all, especially if a tax agent has been engaged (most tax agents know more about the tax system than the average IRB auditor).

¶8-170] Cooperate and get it over with

Unless your records are perfect, the IRB will probably disallow at least one deduction on your return or reclassify some receipt you cannot properly substantiate (perhaps a gift) as income. Most people who get audited end up owing something. An audit is not fun, but the best thing you can do is to cooperate with the IRB officer. With luck, the agent will check out a few basic items and wrap things up quickly!

¶8-165

THE AUDIT PROCESS

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¶8-200] Commencement of audit

Once a case has been selected for audit by the IRB, relying on the various options available to it, a close study of the facts, details, and circumstances will obviously be made by the relevant officers so as to acquaint themselves with all facets of the case. Where the IRB decides that examination of the taxpayer's compliance is better achieved through a field audit rather than a desk audit, a notice will be sent to the taxpayer.

¶8-205] Notice of audit visit

This would generally include the following:

- *the date on which the impending visit would be held*

The taxpayer would usually be given two weeks' notice but if the proposed date is not suitable, the taxpayer could request the IRB to defer the visit to another more convenient date. The audit would be carried out at the taxpayer's business premises but if this is not suitable, an alternate venue may be suggested.

- *the years of assessment which the IRB wishes to examine*

By and large this would be between one to three years but the period covered could be extended should the actual audit indicate that there are more issues to be reviewed than originally contemplated.

- *list of documents and records*

The notice would also list out the various documents and records that the officers wish to examine and the taxpayer is expected to ensure that these records are available on the day of the visit.

- *details of the audit officers*

These would include the names of the relevant officers and their identity card numbers. In addition, the officers would carry the Inland Revenue Authority Cards and the taxpayer has every right to request to see proper identification before allowing the officers entry into the premises. In fact, it is advisable to do so as there have been cases of impostors acting as tax officers.

¶8-210] The actual visit

It must always be remembered that IRB officers carrying out audit or investigation duties do not need any court warrant or similar document to be allowed entry into a taxpayer's house or office. This is because the *Income Tax Act 1967* (ITA) provides officers with the necessary authority to properly and effectively execute their responsibilities. This authority is not limited to mere entry into the premises as the law provides for tax officers to have access to rooms, filing cabinets, computer systems and software, and like places where the taxpayer may maintain records (s 80, ITA).

brought to the High Court by way of a case stated''.

In agreeing with the views expressed by His Lordship Azmi L.P. (as he then was) in dismissing the appeal, Gill FJ (as he then was) at page 165 (left hand column) had opined -

"In place of a Board of Review we now have the Special Commissioners of Income Tax. It is open to a tax-payer to go before them and prove that he is not liable to assessment. The doors of justice are not shut to him merely because the claimant is the Government, but he has to enter the doors of the Special Commissioners first to raise the plea of non-observance of the principle of natural justice or to establish that the Director-General acted arbitrarily and in a

non-judicial manner. It is only after he has availed himself of that remedy as laid down by the law that he has a right to come to the courts''.

Similarly in the present case, the Applicant has argued that he did not owe the impugned sum to the Respondent. Hence, applying the *ratio decidendi* of *Sun Man Tobacco's* case, this Court has no power to entertain his plea by reason of section 106 (3) of the *Income Tax Act*. In this instant case it was submitted by the Respondent that the Applicant did not appeal under section 99 of the *Income Tax Act*. In my view, even if he did, this Court is again precluded from entertaining his plea for the same reason as stated.

CHAPTER 4

EXAMINATION OF DOCUMENTS AND RECORD KEEPING

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EXAMINATION OF DOCUMENTS, REPORTS AND ACCOUNTS

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[¶25-000] IRB scrutiny

The “interviews” or discussions that the Inland Revenue Board (IRB) officers will have with the person who is under investigation or audit are—

- to understand the essentials of his/her income-earning history and if he/she is in business, how it is conducted and the basis of income recognition; and
- to get his/her explanations on issues that would have been met during the IRB examination.

The IRB team can be expected to examine and scrutinise any record or document that would throw light on the accuracy of the returns submitted. This tab covers the particular items and issues that the IRB may want substantiation and clarification on and the respective kind of queries that could be raised.

The records that could draw the IRB’s attention would include:

- accounts, including management accounts;
- internal audit comments;
- invoices and receipts;
- bank statements;
- contracts and agreements;
- Schedular Tax Deductions; and
- income tax computations.

[¶25-010] Basic particulars

The examination would normally start with a study and verification of the taxpayer’s basic particulars, which would include:

- the nature of business and capital contributed;
- personal details of shareholders and directors;

¶25-000

- organisational chart;
- business address and branches; and
- the details of accounts and records maintained.

[¶25-020] Income recognition

- Where businesses are concerned, s 24 of the *Income Tax Act 1967* (ITA) (ie “Basis period to which gross income from a business is related”) holds that a debt arising in respect of stock-in-trade sold or services rendered constitutes gross income. This in effect means that, income from business transactions must be recognised on the “accruals” basis, whether or not the relevant amount has been received from the customer or client.
- Within the parameters of the above principle, there are other considerations to be borne in mind since the Director General (DG) may, under s 82 of the ITA (ie “Duty to keep records and give receipts”), require a person to keep accounts in a particular manner. For example, persons involved in housing development or contracts must maintain their records based on the “progressive profits” or “percentage of completion” method; the “recognition of income on completion” basis is not acceptable.
- On the other hand, all income apart from business income is to be brought into account on the “receipt” basis. For example, if a house is let out and the tenant fails to pay two months’ rent, the person only needs to declare ten months’ rent. Such non-business income and “arrears” shall, when received, be treated as income for the period receivable.

Where the basis required by the DG is not adhered to and this failure results in a “deemed” shortfall of income, additional assessments with penalties may be raised.

Management accounts will also be compared with the final or “submitted” accounts, and where there are discrepancies or differences, explanation must be provided by the taxpayer. Obviously, vast differences between these two accounts would give rise to suspicion that inappropriate changes had been made to reduce liability.

Law: s 24; 82

Accounts

Accounts.....	¶25-030	Trading account.....	¶25-050
Balance sheet.....	¶25-040	Profit and loss account.....	¶25-060

[¶25-030] Accounts

Accounts can loosely be said to come in three categories, namely:

- the balance sheet (see ¶25-040);
- the trading account (see ¶25-050); and
- the profit and loss account (see ¶25-060).

With regard to these accounts, almost any aspect including the items in the profit and loss account can be subject to intense examination. However, minor items may be disregarded and at times, only the balance sheet and trading account might be looked

into. The rationale is that having caught the "big fish" element available in these two principal segments of the accounts, going through the lesser items in the profit and loss account may not be productive, and would be a waste of time of both the IRB officers and the taxpayer. Nevertheless, such concessions may not be available should it be discovered that the person had practised some degree of tax evasion, or it appears to the investigating team that normally small expenses are either high or constitute an unduly substantial portion of the total expenditure.

¶25-040] Balance sheet

In the examination of the balance sheet, the IRB would examine areas such as:

- (a) capital
 - the amount contributed by the proprietor, partners, or shareholders;
 - the schedule of payment if not in a single amount; and
 - whether the amount is commensurate with the person's known income.
- (b) proprietor's/director's current account
 - breakdown of entries reflected;
 - whether trading transactions were included. If so, why?
 - loans/advances given—was interest charged? Where are the sources of funds?
 - the persons to whom loans or advances were given;
 - whether interests received has been declared;
 - how are drawings reflected? and
 - are the sole proprietor's drawings sufficient for his/her needs?
- (c) fixed assets
 - a list of assets owned, including date and cost of purchase;
 - documentary evidence of purchase;
 - actual sighting of assets may be required;
 - how these assets are used in the business;
 - whether industrial building allowance was wrongly claimed;
 - whether any portion of building has been sublet;
 - whether sublet rent has been declared;
 - verification of qualifying expenditure where capital allowance is claimed; and
 - whether expenses on non-business assets were charged to accounts.
- (d) stock
 - the nature of stock-in-hand;
 - the basis of evaluation;
 - the kind of records maintained; and
 - adjustments made in respect of stock written off.

- (e) trade creditors and debtors
 - confirmation that all creditors and debtors relate to trade;
 - list of principal creditors/debtors and respective amounts;
 - credit period granted;
 - how discounts and rebates are reflected; and
 - the method of treating bad debts.
- (f) investments
 - the nature of investments made;
 - date and cost of purchase;
 - verification of supporting documents; and
 - details of income and how they are declared in returns.
- (g) balance at bank
 - details of relevant banks;
 - the purpose of respective bank accounts;
 - how bank transactions are monitored;
 - authorised signatories;
 - reconciliation between accounts and bank statements; and
 - explanations in respect of principal transactions.
- (h) loans and bank overdraft
 - names of banks, financial institutions, lender;
 - the security provided;
 - details of repayment schedule;
 - how loans/overdrafts were utilised;
 - details of interests incurred/paid; and
 - the application of s 33(2), ITA (this section concerns interest restriction on borrowings to finance investment loans).

¶25-050] Trading account

Examination of the trading account would include:

- (a) opening/closing stock
 - reconciliation with stock records and balance sheet;
 - reconciliation of stock brought forward; and
 - has the stock for personal use been accounted for?
- (b) gross revenue
 - verification of basis of income recognition;
 - explanation of documents and records used;
 - how cash sales are recorded;
 - the procedures adopted for recording cash transactions;

- details and explanations on 'unusual' receipts;
 - determination of pricing method used—'mark-up', etc;
 - details of discounts given;
 - reconciliation with bank statements/ledger/debtors list;
 - verification of invoices against ledger;
 - reconciliation of amount declared using opening/closing debtors;
 - details of major customers and sales made to them; and
 - sales tax paid—verification with Customs documents.
- (c) purchases
- general analysis of credit and cash purchase;
 - explanation of documents and records used;
 - details of purchases from overseas;
 - verification of Customs duties on "overseas" purchases;
 - reconciliation with bank statements/ledger/creditors list;
 - reconciliation of amount charged using opening/closing creditors;
 - confirmation that no non-trade or capital purchases have been included;
 - verification of invoices against ledger entries;
 - the system for managing bad debts;
 - verification of bad debts written off; and
 - details of principal suppliers and respective purchases.

¶25-060 Profit and loss account

The profit and loss account shows just how profitable (or not) a business has been in a financial year. The profit and loss account concerns business turnover (the total amount of all sales) and the cost of sales (money paid to suppliers for services or goods).

The profit and loss account is basically turnover minus cost. Cost is subtracted from business turnover to arrive at a gross profit (the revenue), from which all other costs to the business, such as salaries and rent are subtracted. Once you have deducted all costs from the gross profit, you are left with the net profit or net loss. Any tax that have to be paid is based on this final, net figure.

Examination of the profit and loss account would include:

- (a) salaries and wages, bonus and "reward" payments
- list of employees and amounts paid to them;
 - reasons for payment and details of services rendered;
 - details of "special or off-payroll" payments;
 - whether the Schedular Tax Deduction (STD) has been properly complied with; and
 - whether EA/E Form includes all relevant amounts.

- (b) benefits-in-kind
- details of benefits provided to employees;
 - whether such benefits were reflected in the EA Form;
 - whether value of benefits adheres to the IRB's guidelines;
 - addresses of premises provided as living accommodation;
 - whether values were correctly computed; and
 - has the living accommodation value been included in the EA Form?
- (c) professional and management fees
- names and addresses of recipients;
 - reasons for payment; and
 - where made to non-residents, whether withholding tax has been complied with.
- (d) foreign exchange losses
- analysis of losses, including country and currency involved;
 - circumstances under which losses were incurred;
 - were the losses incurred or merely anticipated? and
 - how foreign exchange gains were recorded.
- (e) repairs and maintenance
- analysis of expenses claimed;
 - have adjustments been made for capital or private items?
 - where capital allowance was claimed, whether expenditure qualifies;
 - confirmation that expenses were incurred and not mere provisions; and
 - examination of supporting documents.
- (f) travelling expenses
- names of persons incurring such expenditure and their position in the business;
 - the places visited, duration, and the persons met;
 - the purposes of such visits;
 - whether the charge includes private or personal items; and
 - examination of supporting documents.
- (g) maintenance of motor vehicles
- details and category of vehicles involved;
 - how these vehicles were used in the business;
 - who are non-commercial vehicles allotted to? and
 - has "use of car" been included as employees' benefits?
- (h) advertisements and promotional gifts
- analysis of expenditure and media used;
 - confirmation that expenses relate to business; and
 - confirmation that gifts given qualify under the IRB's guidelines.

income tax returns, to furnish an accountant's report certifying that the requisite documentation or information has been maintained.

A. Company details

- (i) Ownership structure showing linkages between all entities within the MNE.
- (ii) Company organisation chart.
- (iii) Operational aspects of business including details of functions performed.

B. Transaction details

- (i) A summary of transactions with other entities in the same MNE. Indicate the name and address of each entity in the MNE with whom international transactions have been entered into and the type of transactions e.g. purchase of raw material or fixed assets, sale of finished goods, borrowing of money, etc.
- (ii) A summary of transactions similar to the above, conducted with independent parties; or information derived from independent enterprises engaged in similar transactions or businesses.
- (iii) Economic conditions during the time of transactions.
- (iv) Terms of transactions. Also include where applicable contractual agreement with overseas associated parties with regard to: technical assistance fees, management fees, marketing fees, recruitment fees, or other services provided, royalties payable, purchase or rental of equipment or other assets, handling charges, loans, allocation of overhead expenses or any specific expenses (e.g. promotional or advertising) borne by the foreign entity, or other forms of payment made to overseas associates.
- (v) Pricing policy over the past seven-year period.
- (vi) Breakdown of product manufacturing costs.
- (vii) Product price list.

C. Determination of arm's length price

- (i) The pricing methodology adopted, showing how the arm's length price is derived. Please also indicate why that method is chosen over other methods.
- (ii) Functional analysis taking into consideration all risks assumed and assets employed.
- (iii) If a comparability analysis results in a range of arm's length outcomes, please furnish documents relating to all the outcomes. Reasons for choosing that particular arm's length price from the range of outcomes must be given.

Note:

All enquires with regards to this guideline can be forwarded to:
 Audit Division
 Inland Revenue Board
 7th Floor, Block 9
 Government Buildings Complex
 Jalan Duta
 50600 Kuala Lumpur
 Tel. No. 62091000 (ext. 3568, 3848, 3598 & 1615)

CHAPTER 6

COMPUTING INCOME DISCREPANCIES

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¶40-000 Techniques used by the Inland Revenue Board to compute income discrepancies

Following the study of the taxpayer's circumstances, the details of his/her business operations, and the additional information that would have been obtained through discussions and the taxpayer's replies to queries raised, the investigation or audit team will proceed to determine the income shortfall, if any, from the returns for the relevant years. This will be executed through one or more of the several methods available. The approaches taken will range from simple to complex, and at times limited to merely disallowing expenses that had been claimed in the accounts, without making adjustments to the income tax computation. An extension to this would be the Inland Revenue Board (IRB) seeking to ensure that despite the *prima facie* appearance of the accounts being correctly prepared, all income received have been included and that the gross income shown in the accounts is indeed the correct amount.

The actual method that the Director General (DG) may choose to adopt would depend on the quality of the available records and accounts, and the possibilities would include:

- the taxpayer has no reliable accounts at all and the accounts prepared by him/her are mere estimates. Such estimates relate to both revenue or takings and expenses;
- the taxpayer has prepared partially acceptable accounts, partially in the sense that the accounts were correctly prepared for a certain period or that certain aspects of the accounts were properly done; and
- the taxpayer has complete, well-prepared accounts.

The most common techniques used by the IRB are as follows:

- (1) the Accounting Approach (see ¶40-100); and
- (2) the Asset Accretion Method (Means Test) (see ¶40-500).

The two techniques above will be discussed in greater detail in this tab.

ACCOUNTING APPROACH

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¶40-100 Accounting approach

Under this procedure, the accounts and supporting documents are examined in detail to see whether they reflect the declared income. Where the IRB is satisfied that the accounts have been properly drawn up, perhaps the only amendments necessary would be for revenue items that have been excluded or expenses that have been wrongly claimed to be added back to the declared income, thereby increasing the amount that would be chargeable to tax. This method, however, is seldom applied and the more common manner of settling a case would be through the examination and adjustments of a wider range of issues.

¶40-000

This method of accepting the accounts and making adjustments offers a host of items for which further details would be required, and the potential number would increase with the complexity of the business' *modus operandi*. These items would include:

- (i) the analysis of principal expenses and outgoings (see ¶40-110);
- (ii) the verification of amount declared (see ¶40-150); and
- (iii) the reverse determination of gross income (see ¶40-200).

¶40-110 Analysis of principal expenses and outgoings

As mentioned earlier in this publication, a taxpayer's profit and loss account may not be too stringently queried in an investigation or audit exercise, and the emphasis would be on the trading account. Occasionally, particularly in the case of sole proprietors, tax officers may decide to seek further explanation in respect of the details claimed as expenses. An analysis of the expenses claimed would be required, and the actions taken by the IRB would include adding back items in the following categories of expenses contained in the amount charged to the accounts which do not meet the test set by s 33 of the *Income Tax Act 1967* (ITA) of being "wholly and exclusively incurred in the production of income", which is in no way an exhaustive list:

• capital items

As these are not "incurred in the production of income", they would be disallowed. The only small consolation would be that where they qualify for capital allowance, at least a portion of the expense may be recoverable as a deduction!

• private and personal expenses

Again, such items would not be allowed and even if they were, eg insurance premiums paid by a sole proprietor, they cannot be valid charges to the profit and loss account. These items should be claimed as personal reliefs against the total income.

• expenses not related to business

Such expenses may include, for example, travelling and entertainment. The taxpayer may argue that these were incurred for business purposes, but the IRB may not accept the explanation on the grounds that the relationship with the business was too remote and carried more features of private expenses.

• expenses that cannot be satisfactorily substantiated

These, like repairs and maintenance, may possess characteristics of allowable expenditure, but the IRB may choose to disallow them if no supporting documents, like receipts, were presented to confirm that the amount claimed was actually incurred.

• revenue expenses specifically disallowed

Section 33 and 39 lists many expenses that are not allowable, or at least are deductible only under certain circumstances or to a specified sum only. Examples of adjustments that may be made would include the rental of non-commercial vehicles that exceeds the permissible limit and amounts liable to withholding tax in

respect of which no such tax was remitted to the DG when the relevant amount was paid to the non-resident recipient.

Example A:

Travelling	Amount (RM)	Disallowed (RM)
Salesmen's expenses	23,000	
Expo in Korea	14,000	
Surveying markets (London)	11,000	11,000
Administration matters	7,000	
TOTAL	55,000	11,000

Example B:

General	Amount (RM)	Disallowed (RM)
Hire of second-hand car	73,000	23,000
Hire of car (cost RM140,000)	115,000	15,000
Non-allowable gifts	4,000	4,000
Factory/Stock insurance	12,000	
TOTAL	204,000	42,000

The simple examples of "expense adjustments" above are strictly not issues that may be uncovered only in an investigation. They are items that should have been adjusted in an income tax computation by the taxpayer. Where this failure is discovered during an examination by the IRB for a year where self assessment is applicable, it would constitute an "understatement of income" and will be liable to an additional assessment and penalty. This mode of making adjustments can be said to be the simplest, since it only requires a detailed analysis of selected expenditure.

Law: s 33, 39

Verification of amount declared**Verification of amount**

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and agreements	¶40-160
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Income verification — third party confirmation	¶40-164

[¶40-150] Verification of amount declared

Where the IRB believes that the inaccuracies and errors in a taxpayer's returns are of a serious nature, the examination would take on a deeper, more probing hue. The examination would cover almost all stages, from the gross income stated in the accounts

¶40-150

to the chargeable income declared in the returns, and the IRB would first want to establish whether the income declared is the correct figure extracted from all records and accounts, and in accordance with the stipulated principles.

Income verification by the IRB would include:

- accruals (see ¶40-152);
- bank statements (see ¶40-154);
- invoices (see ¶40-156);
- salesmen's order logs (see ¶40-158);
- contracts and agreements (see ¶40-160);
- directors' or proprietors' account (see ¶40-162); and
- third party confirmation (see ¶40-162).

[¶40-152] Income verification — accruals

The gross income of a business must be accounted for on the accruals basis, and adjustments need to be made where a person may have declared income on the receipts basis.

Assuming that sufficient details of the business are available, "cash or receipts returns" may be converted to "accruals" as follows, to determine the income understated:

Example:

Cash takings declared as gross income	RM675,000
Trade debtors at beginning of year	RM54,000
Trade debtors at end of year	RM142,000
Adjustments to be made	
Cash takings	RM675,000
Add: closing debtors	RM142,000
	RM817,000
Less: opening debtors	RM54,000
Actual income accrued	RM763,000
Less: income declared	RM675,000
Understatement of income	RM88,000

In the example above, it is assumed that the figures in respect of takings and debtors are correct and no adjustments are necessary.

[¶40-154] Income verification — bank statements

A variation to the example in "Income verification — accruals" would be where the IRB disputes the gross takings declared and determines this amount through an examination of bank statements and also debtor balances. In such a situation, the bank credits would be tallied to arrive at the gross takings, with adjustments made for non-trade credits. Similarly, non-trade debtors would also be excluded.

¶40-154

Example A:

Gross income (cash takings)		RM787,000
Opening trade debtors		RM91,000
Closing trade debtors		RM186,000
Adjustments to be made		
Total bank credits		RM956,000
Less: non-trade credits		RM137,000
		RM819,000
Add: closing debtors	RM186,000	
Less: non-trade debtors	RM21,000	RM165,000
		RM984,000
Less: opening debtors	RM91,000	
Less: non-trade debtors	RM16,000	RM75,000
Actual income accrued		RM909,000
Less: income declared		RM787,000
Understatement of income		RM122,000

Where the taxpayer wishes to argue that the total bank credits and closing debtors include non-trade amounts, it is incumbent on him/her to identify and substantiate the relevant amounts. It is probable that the taxpayer would not want to question the amount used as "opening debtors" since a bigger sum is to his/her advantage—the taxpayer can be quite certain that the IRB would want details of non-trade amounts included in this balance!

By the same token, where "purchases" are being recomputed to determine the "incurred" amount as opposed to the "paid" amount, the same process will be followed.

Example B:

Cash payments claimed as purchases	RM483,000
Trade creditors at beginning of year	RM79,000
Trade creditors at end of year	RM104,000
Adjustments to be made	
Cash payments	RM483,000
Add: closing creditors	RM104,000
	RM587,000
Less: opening creditors	RM79,000
Actual purchases incurred (allowable)	RM508,000

In reverse to where sales or takings are concerned, it would be the IRB who would want the taxpayer to defend his/her contention that all the withdrawals from his/her bank account represent payment for purchases. The IRB would hold that the bank withdrawals could be for personal or other non-trade purposes. Thus, they may ask the taxpayer to explain with reference to the respective cheque butts, withdrawals that appear questionable. This is to eliminate payments that are not for business purchases as otherwise, the taxpayer may enjoy a deduction higher than what is due to him/her.

Similarly, the taxpayer may be required to give a detailed analysis including respective amounts of closing creditors so that the adjustments made produce a correct and accurate figure.

¶40-156] Income verification — invoices

Among the documents and records that may be taken back to the IRB's office during an investigation or even an audit are those relating to sales made or fees received. These act as a very easy if not accurate means of establishing the gross takings of the business.

Verification of gross revenue or receipts involves a simple process of adding up the values reflected in each of the individual invoices. While the number of invoice books that need to be examined may be voluminous, particularly where the business is large, it must be remembered that the IRB has equally large resources, including data entry manpower whose only work is to key in data sheet by sheet as and when instructed by the investigating officers.

Two points should be borne in mind when the IRB determines gross income by tallying up invoices.

- the IRB would obviously adopt the better of two possible results. If the "invoice" approach produces a higher figure than evident from analysing the bank statements, then that figure will be used as the basis for computing the shortfall in the declared income. However, if the figure of the bank statements is greater, the "invoice" result would be discarded; and
- the most useful "invoice" basis for the IRB would be where the entire collection of invoices is available. But even if this were not so and only a portion of the invoices or those for only a short period rather than the entire period under review were traced, it would not deter the tax authorities as long as the records in hand can provide a reasonably acceptable basis. The limited number of invoices would be used as the foundation from which projections for the entire year or period under study could be arrived at.

Example A:

Gross sales declared	RM1,480,000
Invoice counterfoil books available (Book N, being dated to 31 December, is confirmed to be the last book in the series for that year. Assume the first book for the year was 'A'.)	'L' to 'N'
Total sales per invoice books 'L' to 'N'	RM412,850
Deemed sales per book (RM412,850/3)	RM137,617
Projected total sales (RM137,617x14 books)	RM1,926,638
Gross takings declared	RM1,480,000
Understatement of income	RM446,638

The taxpayer may protest that the projected takings of RM1,926,638 cannot be correct since it does not reconcile with the total bank credits. A possible reply from the IRB would be that some of the sales were in cash and therefore not reported, or that some other means, like an undisclosed account, was used for the excess over the acknowledged bank account.

The above formula may also be employed where invoices for only some months are available.

Example B:

Gross sales declared	RM1,790,000
Total sales per May – July invoice books	RM562,902
Projected total sales (RM562,902/3x12)	RM2,251,608
Gross takings declared	RM1,790,000
Understatement of income	RM461,608

Any challenge by the taxpayer regarding the IRB's computation must be supported by documentary evidence or an acceptable explanation in respect of the difference in gross takings.

Whichever method employed by the audit team, the results obtained may be extended for the other years under examination. This generally means that the same gross profit ratio would be used. The IRB's position would be strong as it would argue that the observations made were all based on the taxpayer's own records and thus, must be in order. Where the taxpayer wishes to have the figures amended, especially for the other years, because he/she holds that using similar gross profit ratios is unreasonable, the taxpayer would have to furnish acceptable grounds for his/her arguments and how the facts and circumstances in the other years differed from the "test" year.

[¶40-158] Income verification — salesmen's order logs

Records in respect of amounts due to or from third parties including employees may often provide the IRB with a good idea of the actual state of affairs, especially where cross-references confirm the tax officers' workings.

Example:

Sales are almost wholly achieved by salesmen and walk-in customers are negligible. The six salesmen working for the business receive a commission of 3% of their sales in addition to basic salaries.	
Gross sales declared	RM1,357,000
Salesmen's commission charged	RM52,430
Total sales per salesmen's order logs	RM1,696,258
Gross sales declared	RM1,357,000
Understatement of income	RM339,258

Two facts are stacked against any argument that the taxpayer may offer against the IRB's computation. In fact, these two points complement each other:

- firstly, the salesmen's logs show that the total sales secured is RM1,696,258, and it is hardly likely that the taxpayer would have permitted them to inflate their sales since this would have resulted in a higher commission payable to them. Thus, the natural inference is that the logs reflect the correct sales figures; and
- secondly, the commission charged to the accounts coincide with the gross sales, and in fact, suggest a slightly higher figure. It would thus be extremely difficult for the taxpayer to dislodge the IRB's computation.

[¶40-160] Income verification — contracts and agreements

Where tax officers have any doubts regarding any income or expenditure, they would want to examine any available contract or agreement. These documents would offer a clearer picture of the true nature of the transaction and especially whether they constitute revenue or capital items. A study of these documents would also reveal whether the relevant amounts were correctly treated.

A receipt, for example, proceeds from an insurance policy, could have been treated by the person to be capital in nature. The IRB would want to peruse the policy in question and having done so, might conclude that the sum received is revenue and thus should be reflected as income. The position would be similar where expenses are concerned, with of course the reverse stand being taken by the respective parties.

It would be appropriate to mention here that when it comes to drafting an agreement, the taxpayer would usually seek the services of his/her lawyer. However, where the agreement may have some bearing to taxation, the advice of a tax consultant should also be obtained. This would avoid unnecessary disputes at a later date if the IRB takes a position contrary to what the taxpayer holds and the stand taken by the tax authorities is founded on an agreement or contract made by the taxpayer.

[¶40-162] Income verification — directors' or proprietors' current account

These two accounts would almost certainly be looked into by the investigating officers and explanation would be required in respect of entries out of the ordinary. The standard "return of loan or advance" clarification may not go far without a detailed tracing of the relevant events by the IRB. If an item in the current account is explained as a loan or advance repaid, the tax officers would want to know how the amount was given in the first place, by looking at cheque butts, bank statements, and entries in the person's records. If there is no satisfactory explanation, the IRB may view the "amount repaid" as undisclosed sales channelled through the director's or proprietor's account.

Even if the entry were a debit to the personal account and described as purchases or other business expenditure paid initially by the director or proprietor, the IRB might not believe the story. This would be because the correct and usual recording requires the relevant amount to be reflected as a loan or advance to the business, and the payment for the expense to be made through the normal business procedure. Any deviation from standard business practices invariably arouses the IRB's interest.

One small comfort is that if the taxpayer has a reasonable justification to treat an amount in a particular manner and the IRB subsequently disagrees with the treatment, any adding back of the amount by the tax authorities may constitute a "technical adjustment" which while liable to additional taxes, would not be subject to any penalty.

[¶40-164] Income verification — third party confirmation

It is sometimes surprising how this simple process of confirmation can produce some telling results! When studying a taxpayer's records, the tax team would note the principal parties that the person does business with. This would include both the income and expenditure sides—those that the taxpayer receives revenue or contracts from and those that he/she makes payments to. Should the figures not reconcile, the taxpayer has the task of explaining the position. At times, however, this would only be a case of a difference in presentation where the ultimate amounts tally. If the taxpayer is able to demonstrate this satisfactorily, no adjustment would be made by the IRB.