CHAPTER 2

LEGALITY ISSUES INVOLVING TAX AVOIDANCE

LEGALITY OF TAX AVOIDANCE

¶2-010 Duke of Westminster doctrine

> "Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."

The above classic statement was made in 1936 by Lord *Tomlin* in *IRC v Duke of Westminster* in support of the doctrine that it is perfectly legitimate for a taxpayer to arrange his affairs to avoid or reduce the incidence of tax. In other words, taxpayers can do whatever they want to reduce their tax liability so long as what they do is not dishonest or specifically prohibited by law, and thereby stray over the line into tax evasion, rather than avoidance. See ¶2-210 for the facts of the *Duke of Westminster* case.

The doctrine is simply one aspect of the principle that taxpayers should be governed by the rule of law – preferably clear and certain laws.

Generally, the Malaysian judiciary embraces the Westminster principle (also referred to as the *Duke of Westminster doctrine*).

¶2-020 Tax avoidance is legal

Tax avoidance is the reduction of one's tax liability by means which are, in themselves, legal. It is to be distinguished from tax evasion, which involves the same result but by means which result in the commission of an offence. Examples of tax evasion are understating income/sales, overstating purchases/expenses or failing to submit tax returns.

Essentially, tax avoidance is the legitimate arrangement of one's financial affairs without violating any tax laws to achieve a reduction of the incidence of taxation. However, there exist some grey areas between tax evasion and tax avoidance.

Lord *Denning*, in the case of *Re Weston's Settlement* (1968), opined that:

> "... the avoidance of tax may be lawful but it is not yet a virtue ...".

Generally, the tax authorities would like to limit the tax avoidance practice if in the opinion of the Director General of the Inland Revenue Board ("DGIR"), the transaction or series of transaction was not *bona fide*, are not commercially justified nor serve a business purpose.

The Malaysian *Income Tax Act 1967* ("ITA 1967") contains anti-avoidance provisions which empower the DGIR to disregard, vary or adjust the transactions despite the legal form.

¶2-030 Tax avoidance, tax mitigation and tax planning

Tax avoidance (or tax minimisation) has also been distinguished from tax planning (or tax mitigation). Tax mitigation was defined by Lord *Templeman* in *CIR v Challenge Corporation Ltd* (1986) as the case when a taxpayer obtains a tax saving or advantage by reducing income or incurring an expenditure which the tax statute permits. Tax mitigation, unlike tax avoidance, involves *an actual expenditure which results in a tax advantage*. An example would be conducting a business by way of an incorporated company rather than a sole proprietorship so as to take advantage of the lower corporate tax rate. An extreme example would be adopting a child (or having a natural child) in order to benefit from child relief.

In the case of *Ensign Shipping Co Ltd v CIR (12 TC 1169)*, Lord *Templeman* provided another definition by remarking that tax mitigation occurs where a taxpayer "suffers a loss or incurs expenditure in fact as well as in appearance". In this regard, a distinction was drawn between tax mitigation and unacceptable tax avoidance:

> "In the former, the taxpayer takes advantage of the law to plan his affairs so as to minimise the incidence of tax. Unacceptable tax avoidance typically involves the creation of complex artificial structures by which the taxpayer conjures a loss, gain or expenditure designed to achieve an advantageous benefit for the taxpayer. They are no more than raids on the public funds at the expense of the general taxpayers, and as such are unacceptable".

Section 140, ITA 1967 not applicable to tax mitigation/planning

Where a taxpayer's business transaction is not carried for *bona fide* commercial reasons or in the ordinary course of a business, s 140 ITA is invoked. In this regard, the legal relationships resulting from a transaction should not be determinative for tax purposes but the economic substance has also to be considered. In *Sabah Berjaya Sdn Bhd v Ketua Pengarah Jabatan Hasil Dalam Negeri* (1999), the Special Commissioners of Income Tax held that certain donations made by the appellant could be disregarded by reason of s 140(1) of the ITA 1967 as it amounted to tax avoidance. The appellant appealed on the ground that the Special Commissioners were wrong in law in holding that the respondent was entitled to disregard the donations as a means of tax avoidance under s 140, ITA 1967. *Gopal Sri Ram* JCA (as he then was) in the Court of Appeal held that s 140 is a comprehensive provision that enables the respondent to disregard any transaction which directly or indirectly has the effect of avoiding the incidence of tax. His Lordship opined as follows:

"...The section is not *sui generis*. It has parallels in other jurisdictions where it has received judicial consideration. Of the cases that have dealt with its equipollent, *CIR v Challenge Corporation Ltd* [1986] STC 548 is the most notable. It is a decision of the Privy Council on an appeal from New Zealand. The Special Commissioners referred to it in their Deciding Order. The Judicial Committee had before it, in that case, s 99 of the *Income Tax Act 1976* of New Zealand. It is a provision that is in *pari materia* with s 140 of the Act.

"Lord *Templeman*, when delivering the majority opinion of the Board, drew a distinction between tax evasion, tax avoidance and tax mitigation. It is only the first two that fall within the purview of the statute: the last does not. In the course of delivering the advice of the Board on behalf of the majority, his Lordship said (at p 554 of the report):

"Tax evasion also can be dismissed. Evasion occurs when the Commissioner is not informed of all the facts relevant to an assessment of tax. Innocent evasion may lead to a reassessment. Fraudulent evasion may lead to a criminal prosecution as well as reassessment ....

"...The material distinction in the present case is between tax mitigation and tax avoidance. A taxpayer has always been free to mitigate his liability to tax. In the oft quoted words of Lord *Tomlin* in *IRC v Duke of Westminster* [1936] AC 1 at 19 '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' ...

"... Income tax is mitigated by a taxpayer who reduces his income or incurs expenditure in circumstances which reduce his assessable income or entitle him to reduction in his tax liability...".

On the facts of the *Sabah Berjaya* case, his Lordship found that:

"... there was a payment that reduced the appellant's income in circumstances in which the Act by way of s 44(6) clearly affords a reduction in tax liability. The appellant here was not engaging in tax avoidance. For, it did not do anything which did not reduce its income or suffer a loss, nevertheless resulting in it obtaining a reduction in its liability to tax as if it had. Accordingly in my judgment this is not a case to which s 140 of the Act applies ...".

Law: s 44(6), s 140, s 140(1); s 99, *Income Tax Act 1976* (NZ).

NEED FOR ANTI-AVOIDANCE MEASURES

¶2-100 Why collect tax?

Taxes are collected to finance government expenditure. Government expenditure encompasses the provision of vital public services such as a national security, maintenance of law and order, healthcare, education and training, disaster relief and infrastructure. Therefore, it is vital that governments act to prevent tax evasion (which is illegal) and to control tax avoidance, since both result in less tax being paid.

Deterrence theory

The word "deterrence", as it is known in the criminal judicial system, is an ancient concept used throughout the history of man in various forms. The earliest known example of deterrence as it relates to crime and punishment is said to be the *Code of Hammurabi*. This ancient text was the first of its kind, a document set forth by a ruling party which categorized crimes and their corresponding punishments (King, 1998). According to King (1998)[1], this code, carved upon a large stone slab and placed in public view, was intended to educate members of society on what is expected of their conduct and what would happen should they violate those expectations. The *Code of Hammurabi* also made it clear that ignorance of the law is no excuse for its breaking, another step along the path of deterrence.

The "Classic Deterrence Theory", on the other hand, highlights that the primary purpose of punishment is deterrence rather than vengeance. Hence, punishment imposed by the authorities must be just severe enough to overcome the gain from a crime. In this regard, punishment that is too severe is unjust, and punishment that is not severe enough will not deter. Consequently, when there is little "proportionality" in imposing punishment (that is: greater the severity of the crime, higher the punishment) individuals will not be deterred from committing more serious crimes.

1 *King, L.W., (1998). Ancient History Sourcebook: Code of Hammurabi, c. 1780 BCE, Retrieved December 14, 2011, Web site: http://www.fordham.edu/halsall/ancient/hamcode.html.Siegel, L., & Senna, J (2006)*

¶2-110 Abusive avoidance

Most tax jurisdictions have sought to strike down what they term "abusive" or "aggressive" avoidance. Abusive avoidance is generally understood to apply to methods, which, while legal, are seen to be contrived and devoid of business purpose. This therefore leads to the question as to whether a transaction should be analysed according to its legal form or its economic substance (see ¶2-180).

It would be considered an abusive practice where:

1. The transactions resulted in a tax advantage which would be contrary to the purpose of the provisions formally applied; and
2. The essential aim in carrying out the transactions is to obtain a tax advantage.

In deciding whether the essential aim is to obtain a tax advantage, it is necessary to determine the real substance and significance of the transactions concerned, taking into account the degree of artificiality of the transactions and any links of a legal, economic and/or personal nature between the operators involved in the scheme for the reduction of tax burden - see *Halifax Plc and others v Customs and Excise Commissioners* (2006); *University of Huddersfield Higher Education Corporation v Customs and Excise Commissioners* [2006] Ch 387.

CASE EXAMPLE: Tax avoidance purpose rendered scheme illegal

In *Lim Kar Bee v Duofortis Properties (M) Sdn Bhd* (1992), the appellant ("the landowner") owned some valuable land at Batu Ferringhi, Penang. The respondent ("the prospective transferee") had been incorporated for the express purpose of a scheme designed to avoid the payment of estate duty in respect of the land in the event of the landowner's death. As part of the scheme, the landowner had entered into a sale agreement purporting to sell the land to the prospective transferee for RM18.97m, and had signed a trust deed which declared that he held the land in trust for the prospective transferee. On an application by the prospective transferee, the High Court had ordered the landowner to transfer the land to the prospective transferee. The landowner appealed raising the argument of illegality. He contended that the shares issued by the prospective transferee in satisfaction of the purported purchase price were illusory shares and a deception on public administration. The prospective transferee maintained that the scheme was to avoid, not evade, duty, and was therefore legal.

The Supreme Court of Malaysia held that the primary purpose of the scheme was to avoid paying the estate duty. The scheme was therefore illegal, as such the agreement of sale and purchase of the land and the subsequent trust deed were unenforceable.

¶2-120 Developments in anti-avoidance doctrines and measures

Since tax avoidance reduces government revenue and may sometimes even bring the tax system into disrepute, governments need to prevent tax avoidance or keep it within limits. The obvious way to do this is to frame the tax legislation so that there is no scope for avoidance. In practice this has not

proved to be entirely successful and has led to an ongoing battle between governments amending legislation and tax practitioners' finding new scope for tax avoidance in the amended rules. Therefore, the use of judicial doctrines to curtail tax avoidance has become pervasive in the area of income taxation. There are several reasons for this:

- If legislation were to be read literally, impermissible tax avoidance would become the norm rather than the exception;
- No matter how perceptive the legislature, it cannot anticipate all events and circumstances that may unfold; and
- Due to linguistic limitations, statutes do not always capture the essence of what Parliament intended.

Judicial principles, therefore, fill the void left either by the legislature or by the words of the legislature. Another reason for the application of these principles is that courts do not want to appear duped by taxpayers; therefore courts apply these principles to reveal the "true essence" of a transaction.

In the UK, judicial doctrines to prevent tax avoidance began in *WT Ramsay v IRC* (1981) followed by *Furniss v Dawson* (1984). However, this approach has been rejected in many commonwealth jurisdictions, including those where UK cases are generally regarded as persuasive. After three decades, there have been numerous decisions, with inconsistent approaches, and both the tax authorities and tax professionals remain quite unable to predict outcomes. For this reason, the application of judicial principles or doctrines can be seen, at best, as being only partly successful.

In 2004, the UK government announced that it would use retrospective legislation to counteract some tax avoidance schemes, and it has subsequently done so on a few occasions. Initiatives announced in 2010 suggest an increasing willingness on the part of Her Majesty's Revenue and Customs ("HMRC") to use retrospective action to counter avoidance schemes, even when no warning has been given. Although the HMRC stated that the move is not a change in policy, taxpayers have claimed that it goes against the principle that the taxpayer is taxed on the wording of the legislation in place at the time of their actions.

¶2-130 Curtailing abusive tax avoidance

To counter tax avoidance, ITA 1967 contains several anti-avoidance provisions. The general anti-avoidance provision is found in s 140, ITA 1967 which purports to void, for tax purposes, arrangements entered into with a purpose of tax avoidance. Section 140, ITA 1967 holds that any transaction that directly or indirectly:

- alters the incidence of any income tax;
- relieves any person from liability to pay income tax or make any return;

- evades or avoids any duty or liability imposed on any person by the ITA 1967; or
- prevents the operation of the ITA 1967.

is void against the DGIR.

As can be observed, this provision can be interpreted to cover a very extensive range of transactions. Besides this general anti-avoidance provision, there are also other specific anti-avoidance provisions contained in ITA 1967 as well as other legislation such as the *Real Property Gains Tax Act 1976*. The statutory anti-avoidance provisions under ITA 1967 are considered in detail in Chapter 3.

In addition to statutory barriers, there are also other non-statutory principles or judicial barriers which might negate the effect of a tax avoidance arrangement. These are discussed in this chapter.

Law: s 140.

¶2-140 Judicial principles that may negate tax avoidance

The Malaysian courts do recognise non-statutory principles and adhere to the principles of *stare decisis*. Such non-statutory principles developed through case laws and judicial pronouncements often guide the interpretation of the anti-avoidance principles.

In view of the very wide general anti-avoidance rule provided under s 140 of ITA 1967, there would probably be little or no need for the DGIR to rely on any non-statutory principles to challenge tax planning arrangements, although the non-statutory principles could provide guidance to the taxpayers. Examples of such principles are the **fiscal nullity doctrine** (which is of doubtful application in Malaysia) and the rules relating to **sham transactions**. See ¶2-300 and ¶2-400 respectively.

Law: s 140.

¶2-180 Form versus Substance – the issues

Form and substance represent two distinct approaches to the interpretation of tax laws in Malaysia and elsewhere.

The exercise of defining the true legal nature of any transaction might involve the question of whether the matter should be analysed according to its stated **form** or according to its broad **substance**.

The "form" approach requires that regard may be had only to the legal form of the transaction while the "substance" approach emphasises that regard should also be had to the economic consequences that attend the transaction. Under the

"substance" approach, attention is focused on whether economic objectives are accomplished by means of some manipulation of the tax laws. If that is found to be the case, the efficacy of that manipulation is denied for tax purposes.

United Kingdom

The form approach to the interpretation of tax law will not invalidate a transaction that is implemented in strict compliance with the specific requirements of the relevant provisions that govern it, regardless of the substantive effect of the transaction. The underlying philosophy of the form approach is that, because tax laws deprive taxpayers of their profits, taxpayers should be entitled – to the fullest extent that those laws allow – to arrange their affairs to minimise tax. The generally accepted view of the UK *Duke of Westminster's* case was such that each matter or step had to be considered in isolation and that other matters could not be considered. The assumption after this case was that form took precedence over substance. Consequently, the major decision in support of the form approach is that of the *Duke of Westminster* case (1936) (see 2-010 and 2-210), so much so that the form approach is often referred to as the *Duke of Westminster* doctrine. However, adoption of the *Duke of Westminster* principle has resulted in some challenges. For instance, in Australia, judicial adherence to a strictly formal or literal approach contributed significantly during the 1970s to the widespread emergence of schemes packaged and promoted by tax avoidance "entrepreneurs". It also progressively resulted in a great volume of complex tax legislation as new areas of avoidance were identified and closed off. A feature of much of that legislation was the wide discretionary powers given to the Commissioner; however many of the Commissioner's discretions have been rewritten and replaced in *Income Tax Assessment Act 1997* ("ITAA 1997") with objective tests.

Broadly speaking, the substance (or policy) approach does not limit its inquiries to the way in which a transaction is formally structured and documented, but goes behind the transaction to examine its substantive effects. The substance approach is widely regarded as being inherently revenue biased and is criticised for being conducive to unpredictable outcomes.

Australia

In addition to the use of extrinsic materials (e.g. official explanatory memoranda, second reading speeches, reports and so on), there are other signs that the courts may be more inclined to look behind the form of a transaction, particularly in cases involving tax avoidance schemes. In the Australian case of *FC of T v Spotless Services & Anor* (1996), the High Court dismissed the *Duke of Westminster* doctrine as irrelevant in determining whether the general anti-avoidance provisions of ITAA 1936 Pt IVA applied to a transaction and noted that, in such cases, the courts must consider *both* form and substance.

United States

The Supreme Court in the US has since 1935[2] adopted two doctrines protective of the tax base, namely: the "business purpose" doctrine and the doctrine of "substance over form".

Under the business purpose doctrine, the courts will disregard any transaction which has no substantial business purpose other than the avoidance or reduction of tax.

The doctrine of substance over form is essentially that, for Federal tax purposes, a taxpayer is bound by the economic substance of a transaction where the economic substance varies from its legal form. The "form" of a transaction is merely the label the parties attach to their arrangement. For instance, an arrangement may be called a compensation agreement, a loan, a lease or a sale. There might be documents that support the form, but the courts are not concerned with these labels or documents that purport to govern the transaction – the courts will focus on the substance of the transaction, regardless of the labels used by the parties.

Law: Pt IVA, ITAA 1936.

2 In the case of *Gregory v Helvering* (1935).

CASE LAW DEVELOPMENTS

¶2-200 General position

The general position is that while each individual transaction could be judged on the merits of its legal form, the totality of a series of transactions could be viewed differently. In administering the revenue law, the tax authorities will, more often than not, construe the statutory provisions purposively and apply them to the facts viewed realistically. They would be entitled to look at the substance of the transactions and not just their legal forms. Where there was a single preordained, composite transaction intended to be carried out in its entirety, the Revenue authorities would not ignore the composite character and apply the tax legislation to the individual constituent steps separately. If the purpose of intermediate steps in a composite transaction were fiscal, the tax authorities would disregard the transaction and apply the relevant legislative provision to it.

¶2-210 Form over substance: *Duke of Westminster* doctrine

The doctrine of depending only on the legally enforceable "form" of a transaction, instead of its economic "substance" or financial result when determining liability to tax, was established in *IRC v Duke of Westminster* (1936). This is the most important UK case before the 1980s on tax avoidance and it concerned annual payments made under covenant over a seven-year period by a taxpayer to his domestic employees. The annual payments were in substance, but not in form, remuneration.

CASE LAW: *Duke of Westminster* decision

The case *IRC v Duke of Westminster (1936)* concerned the characterisation of certain payments made by the Duke to his domestic employees (including his gardener). Payments made under deeds of covenant could reduce his liability to a surtax; payments made as wages to his employees could not. The Duke executed deeds of covenant in favour of his employees, and reduced their wages accordingly, and thus mitigated his exposure to the surtax.

CHAPTER 4

TAX PLANNING

VIEWS ON TAX PLANNING

¶4-000 Introduction

The objective of tax planning is to arrange one's financial affairs in such a manner so as to minimise payment of taxes. Tax planning is allowed as it is considered as a legal tax avoidance scheme. It was mentioned earlier in Chapter 1 that the borderline between tax planning and tax avoidance can often be blurred. Essentially tax planning is concerned with the organisation of a taxpayer's affairs so that they give rise to the minimum tax liability within both the letter and the spirit of the law, whereas those engaging in tax avoidance activity are likely only to seek to comply with the letter of the law. The distinction, however, cannot always be easily applied in practice. Often, characterisation will depend upon prevailing community views, as well as the views of other key stakeholders in the tax system, including politicians, the judiciary, the Inland Revenue Board of Malaysia ("IRB"), tax professional bodies and tax advisers. The views of some of these are considered below, followed by a discussion of some of the principles that inform contemporary tax planning.

¶4-010 Community attitudes and government responses

Any discussion of tax planning cannot take place without reference to prevailing community's attitudes and government responses. The vehemence and frequent eruption of the public debate on matters relating to taxation, and particularly the hazy borderline between acceptable tax planning and unacceptable tax avoidance, is understandable, because these issues touch upon the interests of every individual and group in society as well as the public interest collectively. The national interest in collection of the revenue in order to provide public services is reflected at the individual level by the liability to pay tax. To the extent that some individuals or groups avoid the payment of tax, public services must be decreased (an outcome rarely acceptable to society) or the shortfall met by increasing the tax burden on remaining taxpayers.

It is little wonder that lobby groups of every kind continually argue that one group in society is paying too much tax while others are paying too little. The tendency of such groups is to a large extent to equate the economic interests of their members with the public good. For example, employee organisations typically argue that individual tax rates are so high as to be a disincentive to hard work and that wage and salary taxpayers are disadvantaged by comparison

with the self-employed. By contrast, employer groups usually argue that businesses (especially companies) pay too much tax and need tax concessions in order to expand, employ more staff and invest in capital equipment (such as plant and machinery).

The commercial attractiveness of a tax plan as well as its chances of success is to some extent connected with prevailing community attitudes to tax minimisation. During a period when public sentiment is strongly against tax minimisation, some taxpayers may choose not to engage in such activities for moral reasons or for reasons of public relations. Public relations considerations also become important when deciding whether or not to appeal to the courts in a tax dispute – some taxpayers would simply prefer not to have their names associated publicly with transactions which many of their colleagues or fellow citizens may consider "improper".

Meanwhile, against the background of economic debate about tax policy, the motivation for tax planning remains constant. In the words of Lord *Upjohn*[1]:

> "No commercial man in his senses is going to carry out transactions except on the footing of paying the smallest amount of tax [possible]."

Likewise, clear justification is also found in the classical opinion in the UK, in the tax case of *Commissioners of Inland Revenue v. Duke of Westminster*,[2] where Lord *Tomlin* stated as follows:

> "Every man is entitled if he can to order his affairs so that the tax attaching under the appropriate Act is less than it otherwise would be. If he succeeds in ordering them so as to secure this result then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

Despite the above common law position, a case that would serve to illustrate the potential risks involved is the 2009 Xinjiang case in China that involved the Barbados-China DTA.[3] This case involved the Chinese tax authorities utilising the 1977 OECD Exchange of Information (EOI) article (the protocol that amended the existing China-Barbados DTA in February 2010 to bring in the new EOI version was not yet in effect). Based on the existing provisions in the Double Tax Agreement (DTA), China did not have the taxing rights over the capital gains derived by a Barbados tax resident from the disposal of shares in a Chinese company. As Barbados did not impose tax on capital gains the effect of the Capital Gains article was that such gains would be tax free. China's tax authorities gathered information under its existing exchange of information article and concluded that the Barbados investor was not a

1 *CIR v Brebner* (1967).
2 [1936] AC 1.
3 A protocol to the Barbados-China double tax agreement (DTA) concluded 10 February 2010, entered into force 9 June 2010, applies from 1 January 2011: http://www.mwechinalaw.com/news/2010/chinalawalert0810a.htm

Barbados tax resident. This was concluded based on the information obtained and by applying the principle of substance over form in accordance with their anti-avoidance rule. As such, the company was ineligible to enjoy the treaty benefits under the China-Barbados DTA and the Chinese tax authorities taxed the gains arising from the sale of shares of the Barbados investor.

Governments have responded in a number of ways to the issue of tax avoidance. For example, specific anti-avoidance provisions have been used as a means to combat such avoidance (which is continuing to the present day). Governments have also made a series of significant changes to the tax system.

¶4-020 IRB's attitude

The attitude of the IRB is a major factor which must always be taken into account in tax planning. If it is known that the IRB has ruled or advised contrary to the interpretation which the taxpayer is proposing to adopt, there may be a stronger chance that the matter will end in litigation, with all the expense, uncertainty and delay that this entails. Many taxpayers would prefer not to engage in a dispute with the Special Commissioners even if they are confident that the law supports their claims. Factors which must be taken into account in deciding whether or not to pursue a claim are the requirement that tax in dispute be paid by the normal due date, with any unpaid tax carrying penalties, long delays and high professional costs, all of which must be weighed up against the amount of tax in dispute and the likelihood of a successful outcome.

Taxpayers must also take into account the risk that the Special Commissioners' policy as to the exercise of particular discretions may change markedly over a relatively short time.

While there is always a risk that the Special Commissioners' policy will change, the formalisation of the Income Tax Ruling system and the publication of these rulings, and (particularly) with the advent of advance rulings and advance pricing arrangements, which enable taxpayers to obtain binding IRB determinations on key taxation issues, have significantly increased taxpayer certainty in tax planning contexts.

Generally, the IRB in recent years has adopted a more aggressive public approach to contrived tax schemes and practices.

¶4-030 Judicial attitudes to tax planning

Ultimately it is the courts which act as arbiter in a dispute between the Revenue and the taxpayer as to the application of the tax law to the taxpayer's affairs. Accordingly, tax planning also requires sensitivity to trends in the judicial interpretation of revenue statutes. An obvious difficulty in this context is that a tax planning arrangement conceived and carried out in times of a pro-taxpayer stance by the courts may come before those courts several years later when the

composition of the courts has changed or attitudes have shifted more in favour of the Revenue.[4] The process of gauging judicial attitudes is complicated further by the fact that a point may not be regarded as finally settled until the court hands down a decision. Even then, if the court gives separate judgments, it is possible for a matter to be decided, for example, 3:2 in favour of the taxpayer, with different judges giving different (sometimes contradictory) reasons for supporting one side or the other, thereby leaving an individual dispute settled but with no clear authority for the guidance of other taxpayers.

Perhaps the classic pro-taxpayer statement by the courts is that of Lord *Tomlin* in *IRC v Duke of Westminster* (1936):

> "Every man is entitled if he can, to order his affairs so that the tax attaching under the appropriate Act is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax."

A more colourful statement to the same effect is found in the dictum of Lord *Clyde* in *Ayrshire Pullman Motor Services v IRC* (1929), where his Lordship said:

> "No man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or to his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow – and quite rightly – to take every advantage which is open to it under the taxing statutes for the purpose of depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to be astute to prevent, so far as he honestly can, the depletion of his means by the Revenue."

As discussed in Chapter 2, initially the courts tended to adopt a strict legalistic interpretation of the tax law, which facilitated the exploitation of "loopholes", and thus made tax avoidance easier. Seizing upon the convenient fiction of a (philosophical) difference between avoidance and evasion, the courts greatly expanded the boundaries of the concept of "legitimate tax avoidance". In the result, while tax evaders were heavily punished, ever more elaborate and artificial "schemes" were upheld as effective by the courts – culminating, for instance, in the decision in *Cridland v FC of T* (1977) where a university student who had no apparent interest in farming obtained the benefit of the income "averaging" provisions nominally available only to primary producers, by becoming a beneficiary in a unit trust which carried on a primary production business.

Largely due to community response to tax scandals, the attitude of judiciary generally to tax avoidance has hardened considerably and there has been a significant change in the interpretation of the anti-avoidance provisions. The "modern approach" to statutory interpretation requires that the context be

4 See, for example, *FC of T v Gulland; Watson v FC of T; Pincus v FC of T* (1985) 160 CLR 55; 85 ATC 4765.

considered in the first instance, not merely at some later stage when ambiguity may be said to arise. "Context" is used in its widest sense to include such things as the existing state of the law and the mischief which the statute was intended to remedy.[5]

The courts have also shown that it is prepared to continue to adopt a purposive approach to the interpretation of the general anti-avoidance provisions, arguably to the extent that they have been given an even broader application than was intended when the provisions were first introduced.

5 *CIC Insurance Ltd v Bankstown Football Club Ltd* (1997).

TAX PLANNING ADVICE

¶4-100 Considerations

Tax planning cannot be approached in isolation. One must always be aware of the implications of other areas of law and practice, for example a tax plan may be affected by considerations of stamp duty, land tax, principles of company, partnership and trust law, and so on. If the plan involves an overseas element, one may also need to take into account tax issues in the foreign jurisdiction(s), double tax treaties and the laws of the overseas jurisdiction(s) where any relevant acts or transactions are to take place, likely foreign exchange movements, etc.

Before moving on to the actual mechanics of tax planning, it is important to consider and take into account the following critical matters:

- Look for and document, purposes other than tax avoidance – see ¶4-110.
- Obtain a thorough understanding of the factual background – see ¶4-120.
- Assess the costs, benefits and practicality of the plan – see ¶4-130.
- Consider the legal environment – see ¶4-140.
- Tailor the plan to the taxpayer – see ¶4-150.
- Assess the risks – see ¶4-160.
- Keep proper and adequate records – see ¶4-170.
- Ensure the plan is flexible and maintained – see ¶4-180.

Each of the above is briefly described below.

¶4-110 Look for and document purposes other than tax avoidance

Perhaps the most important fact to be borne in mind is that any arrangement entered into for the sole or dominant purpose of avoiding tax may fall foul of s 140, *Income Tax Act 1967* ("ITA 1967"). Given that minimisation of tax is by definition an objective of any tax plan, it is therefore necessary to be able to demonstrate that this is neither the sole nor the dominant purpose. Effectively,

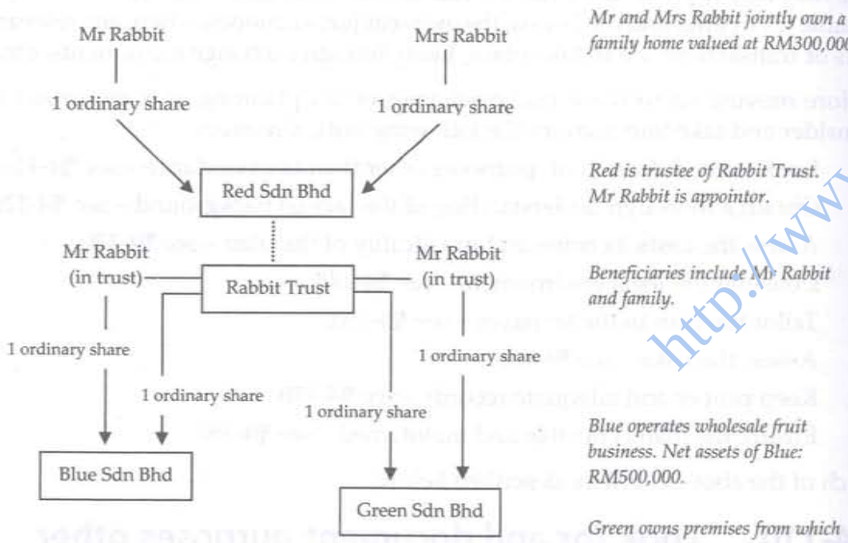
this will require the taxpayer to point to other purposes which can readily be seen as not having a tax avoidance character.[6] Essentially it must be possible to characterise the arrangement as an "ordinary commercial dealing" or an "ordinary family dealing".

Law: s 140.

¶4-120 Obtain a thorough understanding of the factual background

It is essential to obtain full details on all relevant aspects of the affairs of the taxpayer for whom a plan is being prepared, including details of their family and related/associated persons, companies and trusts. This would include the full names, addresses and ages of the individual taxpayers, family relationships, assets and liabilities, income and outgoings as well as details of their business activities.

A flowchart will be of great assistance in gaining a quick understanding of their relationships. An example of what such a flowchart may look like is shown below.



6 In Australian case of *FC of T v Star City Pty Ltd* (2009), the taxpayer found it difficult to contest a contention from the Commissioner that Pt IVA applied when various damning and embarrassing pieces of advice from the company's advisers, to the effect that tax avoidance was the dominating factor in the restructuring that was taking place, were admitted as evidence in the court proceedings.

¶4-130 Assess the costs, benefits and practicality of the plan

A tax plan which costs more to implement than the tax savings generated is obviously of no value. In this regard, a range of tangible and intangible factors must be taken into account as the "costs" of implementing a tax plan. These include:

- Set-up costs such as professional fees and registration expenses (e.g. costs of incorporation or acquisition of "shelf" companies);
- Maintenance costs such as annual filing fees for companies and ongoing professional costs, e.g. for preparation of accounts and tax returns;
- Additional costs incurred under other legislation, for example stamp duties on transfer of assets, and land tax (which may increase if land is transferred to another entity); and
- Increases in the accounting/administrative workload of the taxpayers and/or their staff.

Apart from the costs of a tax plan, commercial and other factors will influence its form and attractiveness. For example, the alienation of income or income-producing assets may not be possible in the case of a taxpayer needing to show certain income to qualify for a loan, or to own certain assets as potential collateral. Similarly, alienation of income to a pensioner may affect entitlement to pension benefits.

¶4-140 Consider the legal environment

Most tax planning arrangements have legal implications beyond the field of revenue law, which must be considered and understood. For example, a tax planner may wish to take advantage of the contrast between the joint and several liability of partners for partnership debts and the limited liability attainable through the use of a corporate structure.

The tax planner must be alert to arrangements which may succeed from a revenue law viewpoint but cannot be carried out except through the breach of other laws. For example, certain professions such as pharmacy can only be practised by qualified individuals, thereby denying practitioners the possibility of "incorporating" their practices.

¶4-150 Tailor the plan to the taxpayer

Tax advisers need to form a view on the business acumen of the taxpayer and others directly involved in a plan and the level of willingness of the taxpayer to become involved in the detailed implementation of suggested arrangements (especially if they are complex). It is essential to tailor the tax plan to the taxpayer, rather than vice versa. It will be of little use providing an effective but highly

and deemed to have accrued in Malaysia was actually sourced in Singapore, SP Ltd should have been taxed.

The Director General contended that the additional income had accrued in Malaysia as attributable income pursuant to Art V although the income had not actually been received in Malaysia. The ingredients of Art V had been satisfied in that the taxpayer had been controlled by SP Ltd, SP Ltd had participated in the management of the taxpayer, the same persons had been involved in the management of both companies, and certain conditions had been imposed which would not have been had the companies been "independent companies" dealing with each other at arm's length. Since certain services were provided by the taxpayer, a portion of the income in dispute actually accrued in Malaysia. The taxpayer and not SP Ltd should thus have been liable for tax. The Director General also took the view that he did not have to consult the Singapore Inland Revenue Department pursuant to Art XX although requested by the taxpayer to do so because no justifiable complaint had been made by the taxpayer pursuant to that Article.

Held: Judgment for the taxpayer.

1. Article V of the Double Taxation Agreements constituted an anti-avoidance provision.
2. The accounting method used by the taxpayer for the period between 1966 and 1971 had reflected genuine commercial realities and the arrangements between the taxpayer and SP Ltd had not amounted to a tax avoidance arrangement.
3. Central management and control of the taxpayer was exercised in Singapore. It was resident in Singapore and not Malaysia; Art V was therefore inapplicable.
4. Assuming Art V was applicable, SP Ltd would be taxable on the income in dispute and the Director General would not be estopped from taxing either company purely because it had not availed itself of the consultative machinery provided by Art XX of the Double Taxation Agreements.
5. SP Ltd had carried on business in Malaysia through the taxpayer.

¶5-084 TPT v Director General of Inland Revenue

Rayuan No PKR 390 (Kuala Lumpur)
(1988) 1 MSTC 224
Special Commissioners of Income Tax
Decision handed down on 6 February 1986

Income tax – Sale of land – Proceeds of sale – Distribution of income – Deemed dividends – Taxpayer shareholder of company – Company selling asset – Company advancing payments to shareholders out of proceeds of sale – Company arguing payments loans

– Revenue assessing taxpayer to tax on basis of payments being deemed dividends – Whether payments loans or deemed dividends – Income Tax Act 1967, s 108

The taxpayer was a shareholder in a private limited company which carried on business as owner of a rubber estate. The company subsequently sold the estate. The proceeds of the sale were placed by way of fixed deposit with a bank. Sums out of the proceeds were withdrawn and interest-free payments described as "advance payments" were made to all the shareholders of the company, including the taxpayer. The payments were reflected as "loans" to the shareholders in the company's accounts. The company never demanded repayment of the "loans" from its shareholders. The company later resolved to be wound up. The taxpayer appealed against an additional assessment raised by the Revenue.

The question for determination was whether on the facts of the appeal the payments made to the taxpayer and other shareholders of the company out of the proceeds of the sale of the land were loans which were not assessable to tax or distributions which were assessable to tax as deemed dividends within the meaning of s 108(5) of the *Income Tax Act*.

The taxpayer contended that the payments had been loans and were not within the ambit of s 108. The loans had been given in proportion to the shares held by the shareholders. The shareholders had a right to participate in the assets of the company. The company had not deemed it necessary to demand repayment of the loans because the company had been able to meet its liability without having to recall the loans. The company had the discretion as to how to utilise the money which would otherwise have been lying idle. There had been no intention to avoid tax and there had been no evidence of tax avoidance at all.

The Director General contended that a limited company not in liquidation could make no payment by way of return of capital to its shareholders except as a step in an authorised reduction of capital. It had not been disputed that at the time of the payments, the company was neither in liquidation nor had there been any authorised reduction of capital. As such, the company must have parted with its moneys by way of distribution of profits. The distribution had been made prior to liquidation and therefore was deemed to be distribution of income. The "loans" had been given to all the shareholders without any condition for repayment and without furnishing any security; they had therefore not been legitimate. The company had never demanded repayment of "advances" from its shareholders. The distribution had been distribution of income and was thus deemed dividend within the ambit of s 108. The entire arrangement had been aimed at avoiding tax.

Held: Appeal dismissed; assessment confirmed.

On the facts of the appeal, the payments made to the taxpayer and other shareholders of the company out of the proceeds of the sale of the land had

been distributions which were assessable to tax as deemed dividends within the meaning of s 108(5).

The payments had been made to all shareholders in proportion to their shares. None of the shareholders had made any request for the "advances". All the shareholders had been given the same treatment irrespective of whether they had been in need of such "advances". These facts fortified the decision that the payments had been distributions not loans. A limited company not in liquidation can make no payment by way of return of capital to its shareholders except as a step in an authorised reduction of capital. When the payments were made to the taxpayer, the company had not been in liquidation. At that time no deduction of capital had been authorised by the Court. The purported "loans" given by the company to the taxpayer on both occasions had been distributions of capital profits to the taxpayer as one of its shareholders. Any such distributions under whatever name given by the company or its director would amount to dividends in the hands of the recipients and would be chargeable to tax under s 108.

¶5-088 SBP Sdn Bhd v Director General of Inland Revenue

Rayuan No PKR 369 (Kuala Lumpur)
(1988) 1 MSTC 2,053
Case stated by the Special Commissioners
Case stated on 3 December 1985

Income tax – Tax avoidance – Invoking of governing provision – Taxpayer ceasing operations – Taxpayer subsequently purchasing another business – Director General disallowing taxpayer from carrying forward unabsorbed losses and offsetting these against future business profits – Taxpayer appealing against additional assessment – Whether taxpayer acquiring business to set off its losses against the business – Whether Director General entitled to invoke governing provision – Income Tax Act 1967, s 140

The case concerned the issue of tax avoidance. After the taxpayer (formerly known as TC) had ceased its mining operations, it acquired a sole proprietorship. The option to acquire had been granted by the sole proprietor C and signed by L purporting to be a director of the taxpayer. The taxpayer's board of directors approved the transfer of its shares to C and L. C and L were later appointed directors. The taxpayer then purportedly ratified the option signed by L when she had not been a director of the taxpayer. Unabsorbed losses of the taxpayer incurred prior to the acquisition of T had been disallowed by the Director General from being offset against future business profits made by the taxpayer. The taxpayer appealed against an assessment and an additional assessment levied for two consecutive years of assessment.

The question for determination was whether the Director General was entitled to invoke the provision of s 140 (covering anti-avoidance) of the *Income Tax Act* so as to disregard the following transactions:

(a) The acquisition of T by TC; and

(b) The transfer of all shares of TC to both C and L.

Held: Appeal dismissed; assessment and additional assessment confirmed.

The Director General was entitled to invoke the provisions of s 140 so as to disregard the following transactions:

(a) The acquisition of T by TC; and

(b) The transfer of all shares of TC to both C and L.

The purpose of the taxpayer had been to set off the losses of TC against that of T so as to alter the incidence of income tax, which would otherwise have been payable by C or to relieve C of any liability to pay income tax which would otherwise be payable if the acquisition had not taken place. TC was virtually an empty shell having sold even its mining assets and its only "asset" had been the tax avoidance asset of unabsorbed losses. The steps taken not only after but before the merger showed clearly the unerring purpose of effecting a tax avoidance scheme and nothing more or less than that. The purported approval and signing of the option agreement by L who was not a director of TC and the resolution seeking to ratify that irregularity provided strong surrounding circumstances as to a pre-conceived scheme to avoid tax. It had also been more than strange that despite the prospect of having taken over a choice picking (T) the shareholders and directors of TC agreed tamely to sell their shares en bloc thereby providing C and L with absolute control over the taxpayer's share capital. Another strange aspect of alleged commerciality was that on the following day the other directors tamely resigned leaving the way open for C and L to control and direct the company.

The reasonable conclusion on the facts was that C the brain behind the scheme from start to finish had engineered the complete takeover of TC (under the guise of TC taking over T) so as to obtain a tax avoidance benefit.

¶5-092 Comptroller of Income Tax v AB Estates Ltd

Federal Court Civil Appeal No X13 of 1966 (Ipoh)
(1950–1985) MSTC 95
Federal Court of Malaysia
Judgment delivered on 5 September 1966

Income tax – Avoidance – Taxpayer leasing estate at uneconomic rent – Whether transaction to be disregarded as artificial – Meaning of "artificial" – Income Tax Ordinance 1947, s 29 (now Income Tax Act 1967, s 140)

The taxpayer company acquired a rubber estate and leased it to a subsidiary at $1,200 p.a. The fair rental at that time was about $16,000 p.a. The Comptroller of Income Tax disregarded the lease as one which was in the nature of an artificial transaction. The Board of Review decided in the Comptroller's favour but the taxpayer appealed successfully to the High Court. The Comptroller appealed.

Held: Appeal allowed.

The taxpayer had planned a scheme to acquire a "tax loss" company and lease the estate to it at a low rental so that tax would fall as lightly as possible on the taxpayer. The lease was not a transaction in the ordinary course of business and therefore the transaction was artificial.

¶5-096 YEHHSB v Ketua Pengarah Hasil Dalam Negeri

[(2010) MSTC 10-007]
Special Commissioners of Income Tax
Case stated delivered on 29 January 2010

Revenue law – Income Tax – Deductability of directors fees under s 33(1) ITA – Chargeability of port handling charges under s 4(a) ITA – s 140 ITA anti-avoidance provision – Placing of company funds in fixed deposits under director's names to get tax exemption – Submission of incorrect returns s 113(2).

The taxpayer was principally involved in the businesses of property investment and he was also a shipping agent. The taxpayer became a partner in a partnership LB & Co in 1985 which had two main Singaporean customers namely PIL Pte Ltd and ACL Pte Ltd. LB & Co was a shipping agent for these two companies at the Penang Port. The taxpayer's income was largely derived from shipping agency activities, whereby it collected agency fees, cargo operation charges, monitoring fees and ship husbandry fees. The appellant received commissions in relation to these terminal handling charges.

The IRB raised notices of assessment under s 4(a) of the *Income Tax Act 1967*, treating this commission received as business income. The IRB also disallowed deduction of director's fees and allowances paid to one of the taxpayer's directors on the basis that these were not wholly and exclusively incurred in the production of gross income. YEHHSB gave interest free loans with no fixed repayment terms to its directors from time to time. The directors placed these amounts in fixed deposit accounts in different financial institutions from which interest income was derived. The interest income was exempt from tax for the directors as the deposits were below RM100,000 each and were placed by individuals. The interest income would have been taxable had the company placed the deposits. The IRB subjected the interest thereon to tax as income

of the appellant and not the directors and invoked s 140, the Malaysian anti-avoidance provision.

There were four issues in this case.

The first issue was whether the terminal handling charges collected by the appellant should be recognised as gains or profits from a business.

The IRB also disputed the deductibility of director's fees and allowances paid to one of the taxpayer's directors for the years of assessment 2000 to 2002. This was the second issue.

The IRB took the view in the third issue that the interest income of the fixed deposits placed by the directors should be taxed on the company thereby invoking s 140 of the ITA.

The last issue was whether the appellant had submitted incorrect returns for years of assessment 2000 to 2002 when the interest income was not brought to tax and therefore subject to penalties under s 113(2).

Held: The appeal was allowed on the second and fourth issues and dismissed on the first and dismissed on third issues.

The Special Commissioners held the terminal handling charges were collected in the course of the taxpayer's business and should be brought to tax under s 4(a) of the Act. The appellant had received commission and these sums were classified as debts to the principal.

The Directors' fees and allowances were held to be deductible under s 33(1) of the Act as the relevant director added value for the taxpayer. The director had been involved in the business for decades and was the wife of the founder, whose presence in the business generated goodwill for the appellant.

On the issue of the interest on fixed deposits placed by the directors, it was held that the interest income should be assessed on the company as it was proven that the funds beneficially belonged to the taxpayer as the funds were withdrawn by the directors as and when the funds were required by the taxpayer. It was evident the scheme was thought out by the taxpayer to alter its tax position. The Special Commissioners held that the IRB was correct in invoking s 140 in this case.

The taxpayer did not have a legal interest in the funds as these were placed in fixed deposits by the directors. The Special Commissioner held that penalties should not be imposed on the taxpayer under s 113(2) for incorrect returns for not reporting the interest income.

An appeal has been filed in the High Court as both the appellant and respondent were dissatisfied with decision.