# The New Outlook on Investment Holding Companies: *post* Finance Act 2005

*Choong Kwai Fatt**

## Introduction

Since the incorporation of the investment holding company (IHC) legislation in s 60F of the Income Tax Act 1967 (the Act) with effect from year of assessment (YA) 1993,[1] it has been accepted that IHCs merely derive investment income such as dividends, interest and rental. However, in the recent High Court decision of *Fernrite Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri*[2] it was held that an IHC will be accorded the same treatment as an investment dealing company and its income will be assessed as business income (s 4(a) of the Act).[3]

A business source is given preferential treatment as compared to an investment source as it claims capital allowances, has current year losses and is able to set off unutilised business losses brought forward. With *Fernrite*'s decision, IHCs income computed with the business source concept will have lower income tax payable as compared to its earlier investment source concept. This tax treatment of IHCs income based on business source is consistent with all companies having business sources such as investment dealing companies, manufacturing companies, trading companies or service providers. It also complies with the tax neutrality policy in a tax system.

This landmark decision delivered by the eminent tax judge Faiza Tamby Chik J is short lived with the recent budget 2006 proposal to amend s 60F via the Finance Act 2005. The new amendments are with effect from YA 2006 onwards.

This article examines the newly amended legislation and concludes that it contains more contentious issues rather than clarifying the law to guide taxpayers in the self assessment regime.

## The concept of IHC

With effect from YA 2006, IHC is redefined to mean "a company whose activities consist *mainly* in the holding of investments and not less than 80% of its gross income (whether exempt or not)[4] is derived therefrom".

* Associate Professor, Tax Consultant, Faculty of Business and Accountancy, University of Malaya.

[1] Finance Act 1993 (Act 497).

[2] [2005] 3 AMR 743.

[3] Ibid at p 775.

[4] The previous legislation refers to a IHC as a company whose activities consists *wholly* in the making of investments and whose income is derived therefrom. It applies to assessments prior to YA 2006.

Section 60F is further amended to provide that the income from the holding of investments shall not be treated as business income under s 4(a) of the Act and, income other than income from holding the investment will be treated as s 4(f) income.[5] This new legislation serves as an anti avoidance provision, preventing companies from camouflaging its management services as a business source into the IHC and setting off a large portion of expenses against it. It also denies companies having several units of properties to have its rental income assessed as business income, relying on the Malaysian landmark Privy Council decision of *American Leaf Blending Sdn Bhd v DGIR.*[6]

## The computation

With this amendment, IHCs are not allowed to compute its income from the holding of investments as business income. It can only include s 4(c) dividend income, s 4(c) interest income, s 4(d) rental income and s 4(f) other income. No capital allowance or current year losses is available to IHCs. Any unabsorbed losses carried forward from YA 2005 can never be utilised within the IHCs.

The new IHC concept continues to be unfavourable with the deduction constraints. It severely restricts the deduction of overhead expenses incurred in the IHC. Section 60F, since its insertion into the Act from YA 1993, has restricted the deduction of permitted expenses into the following statutory formula:

$$A \times \frac{B}{4C} \quad \text{or}$$

$5\% \times B$ Which ever is the *lower*

Where A is the total of the permitted expenses incurred for that basis period reduced by any receipt of a similar kind;

"*Permitted expenses*" means expenses incurred by an investment holding company in respect of –

(a) directors' fees;

(b) wages, salaries and allowances;

(c) management fees;

(d) secretarial, audit and accounting fees, telephone charges, printing and stationery costs and postage; and

(e) rent and other expenses incidental to the maintenance of an office which are not deductible under s 33(1).

[5] Section 60F(1A) was inserted into the Act and takes effect from YA 2006 onwards.

[6] [1979-1996] AMTC 903.

B is the gross income consisting of dividend, interest and rent chargeable to tax for that basis period; and

C is the aggregate of the gross income consisting of dividend (whether exempt or not), interest and rent, and gains made from the realisation of investments for that basis period.

C = B + exempt dividends + gains made from the realisation of investment.

In conclusion, IHCs are restrict in the deduction of permitted expenses. Where an amount in A is incurred, the maximum expenses that is deductible is only 25% of A.[7] The fraction of permitted expenses are deducted from the aggregate income to arrive at the total income of a IHC.[8]

## Presumption of being an IHC

Section 60F(1B) was inserted to the Act and sets down the IHC presumption application. Once a company has been established as an IHC between the tax authorities and the company, it shall be presumed the company continues as an IHC for all subsequent years of assessment unless the contrary is proven.

Under the self assessment regime, the company may have to apply the YA 2005 tax computation to gauge whether it falls into the category of an IHC for YA 2006. Proper tax planning which is discussed below is required to ensure it is not IHC.

## Management alert

The newly amended IHC concept requires that at least 80% of its gross income (including exempt income) must be derived from investment sources. Although exempt income is not taxable, it is however used to examine whether a company is an IHC.[9]

Once this condition is fulfilled, income other than investment income is treated as s 4(f) income.

[7] See Choong Kwai Fatt, *Advanced Malaysian Taxation – Principles and Practice*, 2005, 7th edn at pp 98-100.

[8] Tax practitioners who require a copy of the format of tax computation examples of IHC post and pre Finance Act 2005, please email the author at kwaifatt@um.edu.my or kwaifatt@yahoo.com.

[9] For examples of exempt income, see Choong Kwai Fatt, *Malaysian Taxation – Principles and Practice*, 2005, 11th edn, pp 7, 181-182 and 193-194.

| Case Study | 1 | | 2 | | 3 | |
|---|---|---|---|---|---|---|
| Gross income | RM | | RM | | RM | |
| Management fees | 40,000 | | 60,000 | | 40,000 | |
| Investment income<br>(include exempt income) | 160,000 | 80% | 160,000 | 73% | 140,000 | 78% |
| | 200,000 | | 220,000 | | 180,000 | |
| | IHC | | ≠ IHC | | ≠ IHC | |

Management may exercise its discretion to either increase management fees or reduce investment income in YA 2006 and subsequent years to avoid being labelled as an IHC. If the company falls into the category of an IHC, management fees would be treated as s 4(f) income and no capital allowance and current year business losses is accorded.[10]

## The unresolved issues

As mentioned above, an IHC is redefined to mean "a company whose activities consist *mainly* in the *holding of investments* and not less than 80% of its gross income (whether exempt or not)[11] is derived therefrom". Decide whether acquisition of assets tantamount to "holding of an investment", "dealing with an investment" or "holding of a trading stock" is never easy. It has to be examined within its peculiar facts. To be an IHC, it has to be "holding an investment" and this sets the demarcation line.

An IHC is a company incorporated with the primary objective to invest its share capital or borrowed fund in shares, real properties, unit trusts, bonds or deposits in order to derive dividend, rental or interest income. The issue whether an activity constitutes "making an investment" or "carrying on business" is a question of law, to be decided by the courts. Generally, a business is said to exist if there is repetition of transactions, short period of holding, profit intention and is carried out using a profit making structure.

Companies incorporated with the objective of investment dealings and which actively buy or dispose shares and/or landed properties for profit is prima facie carrying on business. In situations where there is economic down turns, such companies may withhold its funds temporarily to acquire shares or landed properties and can never be treated as an IHC even if it derives dividend or rental income at the time it was quiescent.

[10] For a detailed discussion on business source versus investment source, see n 7 above at pp 515-517.

[11] The previous legislation refers to an IHC as a company whose activities consists *wholly* in the making of investments and whose income is derived therefrom.

In *JP Harrison (Waford) Ltd v Griffiths*[12] Danckwerts J opined:[13]

> When you find that there is a trading company and it acquires the shares in question for the purpose of making a profit out of those shares, and it makes profit by getting an enhanced price on resale or by getting an advantage out of the temporary possession of the shares in the form of dividend, to my mind it is dealing in the shares in the course of its trade and not in any other capacity whatever."

Raja Azlan Shah FJ (as His Royal Highness then was) in *I Investment Ltd v Comptroller General of Inland Revenue*[14] held that a company carrying on a business need not necessarily always have high frequency transactions as the business cycle can be up and down. His Lordship held:[15]

> If a company was formed to carry on business, and in fact it carried it on, I think, it cannot matter that its activities had been an isolated one … A company's business may have been quiescent for a number of reasons. For example, following a business set-back, consolidating its business waiting for the ripe opportunity to occur … If the company still carries it on, then I think the company is carrying on business.

A company incorporated with business object to provide management services, trading or carrying on manufacturing, may utilise its excess funds to derive investment income. Such companies cannot be termed as IHCs even thought 80% of their gross income is from investment income. The primary objective that it never intended to be an IHC is conclusive evidence and must be accepted by the tax authorities. The determination is based on circumstances and degree, a question of fact to be decided and argued at the special commissioners upon further appeal.

Likewise, in a securitisation exercise, a special purpose vehicle (SPV) company is incorporated to issue bonds to finance the construction project of its holding company and will release its bond proceeds in trunk batches while the excess funds will be placed in money market. It derives interest income from the money market and pays the bond interest to its investors and therefore can never be held as an IHC.

The SPV is carrying on business. The series of transactions, continuity and repetition of funds placement and paying interest over a period of time to bondholders are strong evidence pointing towards business. The interval between

[12] 40 TC 281.

[13] Ibid at pp 285-286.

[14] [1937-1978] AMTC 721.

[15] Ibid at p 731.

the investment of funds in money market and the payment of interest to bondholders may be short or long and is never a criteria to decide the issue of carrying on a business.

In *American Leaf Blending Co Sdn Bhd v DGIR*[16] Lord Diplock remarked:[17]

> The carrying on of "business", no doubt, usually calls for some activity on the part of whoever carries it on, though, depending on the nature of the business, the activity may be intermittent with long intervals of quiescence in between.

In conclusion, we have to examine the first object of the memorandum of association of a company to determine its true objective, whether making an investment or professing to carry on business. The acid test is to look at the nature and purpose and the substance of the transaction and, in doing so, one may have to go behind the technicalities. Clark LJ acknowledged the difficulty in *California Copper Syndicate v Harris* and said:[18]

> What is the line which separates the two classes of cases [investment or business] may be difficult to define, and each case must be considered according to its facts; the question to be determined being – is the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in an operation of business in carrying out a scheme for profit making!

## Burden of proof

The taxpayer has the onus of showing that a company is not an IHC in YA 2006. The tax authorities during the tax audit may issue additional assessment if they contend otherwise. The assessment shall stand unless and until the taxpayer satisfies the tax authorities, the special commissioners or the court that such additional assessment is wrong. It is of utmost importance for the taxpayer to keep proper accounts in connection with the investment or business activities as required by s 82 of the Act. Lack of documentary evidence is an important factor which no doubt would influence the tax authorities in drawing an adverse inference that the company is an IHC.

## Conclusion

It is felt that the Act should not discriminate investment holding companies from other companies such as investment dealing, manufacturing, trading or service companies. It is an accepted legal principle that the mere setting up of a company

[16] [1979-1996] AMTC 903.

[17] Ibid at p 908.

[18] 5 TC 159 at pp 165-166.

points to its business intention because of its implied continuity.[19] That would be a strong presumption that it intends to do business. In addition, neutrality of tax treatment has to be preserved to ensure the tax system is fair to all taxpayers. The latest amendment to IHCs may result in companies spending unnecessary cash resources to engineer tax avoidance schemes to frustrate the operation of s 60F. In the long run legal battles merely reduce the competitiveness of a firm and result in less tax revenue for the country.

[19] It was first propounded by Lord Diplock in *American Leaf Blending v DGIR* [1979-1966] AMTC 903, accepted and applied in subsequent case of *I Investment v CGIR* [1937-1978] AMTC 721.