

The Demarcation between Ministerial Exemption under s 127 and Schedule 6 Exemption

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Introduction

The Income Tax Act 1967 (the Act) is founded on the golden principle that “no income, no tax”. It is legislated to compute the income tax payable by a person, be it an individual or a corporation. If income is to be taxed, then it would be included in the tax computation by going through the various stages of income beginning from gross income, adjusted income, statutory income, aggregate income, total income to chargeable income as stipulated in s 5 of the Act. Schedule 6 to the Act would exempt income if required conditions are satisfied.

The Minister of Finance however is empowered to exempt classes of person in relation to particular sources of income by virtue of s 127 of the Act. The crux of the issue is whether in such a scenario, a taxpayer is required to include the exempt income into computation by going through the various stages of income and then later exclude it from chargeable income or whether it should be excluded from the very beginning, i.e. at gross income level.

The distinction is important as it involves additional tax payable, additional compliance cost to the computation and additional records to be maintained. In *Ketua Pengarah Hasil Dalam Negeri v Perbadanan Kemajuan Ekonomi Negeri Johor*,¹ the Court of Appeal provided its answer.

The Saga begins ...

In *Ketua Pengarah Hasil Dalam Negeri v Perbadanan Kemajuan Ekonomi Negeri Johor*, the Court of Appeal overruled both the High Court and the Special Commissioners’ decision and held that an approved donation has to be apportioned between exempt business income and taxable dividend income. The income exemption stated in s 127 referred to chargeable income. The decision differs from both the High Court and the Special Commissioners which had unanimously held that income exempted in the s 127 exemption refers to gross income and the exempt income should not be included in the tax computation.

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1 [2009] 3 AMR 569.

The taxpayer was a statutory body incorporated under the Johor State Enactment No 4 of 1968 and had been exempted from tax for business income by virtue of s 127 of the Act. However, the Minister's exemption under s 127 did not specify whether the exemption was on gross income or chargeable income level. The taxpayer made an approved donation under s 44(6) of the Act and claimed such deduction against dividend income received. The tax authorities however applied their discretion to apportion the deduction between the exempt business income and dividend income. Thus the Revenue issued two notices of assessment for the following tax payable:

YA	Income Tax Payable (RM)
1991	2,824,507
1992	1,978,745

Being dissatisfied, the taxpayer appealed. The Special Commissioners held that the s 127 exemption should be at gross income stage, thus business income was extinguished from the inclusion in the tax computation. This would result in dividend income being the only source of income and the full amount of the donation being deducted against the dividend income. This was affirmed by the High Court.

The tax authorities however submitted that in any s 127 exemption, the word "income" as stated in s 127 means "chargeable income". The business income although exempted, had to be included in the tax computation, together with the taxable dividend income and the approved donations deducted to arrive at chargeable income. Then the apportionment of chargeable income was based on exempt business income and dividend income. This would result in additional work being done and require an apportionment formula which is not provided in the Act. In short, IRB contended that the s 127 exemption should be on "chargeable income" and not gross income.

The Court of Appeal founded the support on the s 127 exemption being based on chargeable income through the Supreme Court's decision of *Lower Perak Cooperative Housing Bhd v Ketua Pengarah HDN*² where Edgar Joseph Jr SCJ held:³

Where its business dealings result in a profit which is income, liability to income tax arises, subject to the right of a co-operative society to claim exemption under paragraph 12 of Schedule 6 for the first five years of its trading or business dealings. In other words, there must be liability to income tax first and then only the question of claiming exemption under paragraph 12 of Schedule 6 arises.

2 [1979-1996] AMTC 1638, SC.

3 Ibid at 1683.

Lower Perak's case was decided on a Schedule 6 exemption. In a Schedule 6 exemption, the taxpayer must first compute its income till chargeable income and make a claim on exemption. The exemption is not provided as of right but depends on the availability of chargeable income in that year of assessment.

Distinction between s 127 exemption and Schedule 6 exemption

The Court of Appeal decided that the s 127 exemption was based on chargeable income, relying on the previous Supreme Court's decision in *Lower Perak's* case. With greatest due respect, his lordship has equated the s 127 exemption to the para 12 of Schedule 6 exemption, which are two entirely distinguishable different concepts. The s 127 exemption is a specific exemption given by the Minister of Finance to exempt the business income of the taxpayer through gazette order. This exemption is granted to the taxpayer as of right without seeking relief by satisfying conditions as stipulated in Schedule 6 of the Act.

In the s 127 exemption, the taxpayer need not apply to claim the exemption. It is given from the very beginning of business operation. Irrespective what is the business status, being profitable or loss, its income is disregarded for the purpose of the Act as stated in s 127(5). Thus income exempted in s 127 must have referred to gross income so that such exempt income is not included in the computation. In para 12 of Schedule 6, the legislature allows a co-operative society to claim exemption provided:

- (a) it is within the first five years commencing from the date of registration
- (b) members' fund at the first day of the basis period for the YA \leq RM750,000.

These two exemptions are distinguishable. The Schedule 6 exemption from tax comes into operation provided an income is first taxable, then s 5 would describe the manner in which chargeable income is to be ascertained. If there is chargeable income, then the taxpayer would seek relief under Schedule 6 for an exemption of tax. The Schedule 6 exemption must be claimed. It is not available automatically.

On the other hand, the s 127 exemption allows the Minister by statutory order to exempt any class of person in respect of any class of income of a particular year and it is to be disregarded for the purpose of the Act. Section 127(5) spells out in clear terms that "any income which is exempt from tax by virtue of this section shall be disregarded for the purpose of this Act". The genesis of the Act is "no income, no tax". If income is to be disregarded, it would be disregarded "from the very beginning of the tax computation", i.e. the gross income stage to affirm the exemption. On the other hand, if an income is to be taxed, then s 5 would come into play, setting out the various types of income that the taxpayer has to begin to compute namely, gross

income, adjusted income, statutory income, aggregate income, total income to chargeable income.⁴

Low Hop Bing JCA, who delivered the Court of Appeal's decision, however, held that the "income" to be disregarded from tax under s 127(5) refers to chargeable income. His lordship held:⁵

To be disregarded under the Act, an exemption from tax should legally be deducted or claimed from the chargeable income and not the gross income. This is because gross income per se may or may not be exigible to tax at all. When no tax is exigible, there is no question or necessity for the taxpayer to utilize or claim the exemption. In the context of s 127(5), exemption means immunity, dispensation, exclusion, freedom, relief or exoneration from tax.

With greatest due respect, this proposition of law has the following setbacks. Firstly, the s 127 exemption is not to be claimed as envisaged by his lordship. It is granted by the Minister through gazette order by virtue of s 127 of the Act. It is available as of right and at the beginning of the year of assessment irrespective of whether the business is profitable or not. Secondly, the scheme of the Act since its enactment in 1967 has laid down the various steps to compute a source of income till chargeable income. The fundamental principle is based on the rule that income is to be taxed, thus it begins from the determination of gross income, adjusted income, statutory income, aggregate income, total income to chargeable income. The purpose of the Act being legislated is to compute taxation. The various concepts of the income stipulated in s 5 are to facilitate the computation of tax.⁶ If an income is exempted, there is no requirement to do any computation. It means gross income is exempted.

Thirdly, If the Act wishes the exemption of a source to be computed till chargeable income, it would have laid down the formula to apportion the chargeable income between taxable and exempted, which is however never prescribed in the Act. If income is to be exempted from tax, it would be rightly exempted from the very beginning, i.e. at gross income level. There is no need to go through the various steps at computation from gross income, adjusted income statutory income, aggregate income, total income to chargeable income. It will not be brought into the computation. The Act is formulated for the computation of income tax; where there is no income due to exemption, there is no requirement to go through s 5 of the various stages of income.

The purpose of the s 127 exemption is to provide certainty. The Parliament never intended to require a taxpayer to compute till chargeable income to seek

4 For a comprehensive discussion on s 5 application, see Choong Kwai Fatt, *Malaysian Taxation – Principles and Practice*, 15th edn (Publisher? Place?, 2009), pp 41–69.

5 [2009] 3 AMR 569 at 577.

6 See Choong Kwai Fatt, *Malaysian Taxation – Principles and Practice*, 15th edn (Kuala Lumpur: Infoworld, 2009), pp 70–71 for chart analysis of the computation aspects.

the availability of exemption. Where there is no chargeable income, exemption is not applicable but where there is chargeable income, then exemption is applied. This would create anomalies and additional work which was never intended by the Parliament.

In conclusion, the phrase “any income which is exempt from tax by virtue of s 127 shall be disregarded for the purpose of this Act” would only mean that it shall be disregarded from the very beginning, i.e. from the gross income stage. It is never brought into tax computation. That the s 127 exemption is distinguished from Schedule 6 of the Act can gain support from the opening s 127 which provides:

Notwithstanding any other provision of this Act

- (a) any income specified in Part 1 of Schedule 6 and
- (b) the income of any institution, person, authority or fund specified in Part 11 of the Schedule

shall subject to this section, be exempt from tax.

This again lends support that s 127 allows the taxpayer as of right to disregard the provision of the Act, i.e. no computation is required on the exempt income.

Section 127 exemption – which income does it refer to?

Income tax is taxed on income. If income is to be exempted from tax, it would have to be disregarded from gross income. It would never be required for inclusion in the computation. Parliament in its wisdom has long recognised this golden rule. Therefore, if the legislature wished otherwise, it would have stated so, as seen in the various subsidiary legislation in PU(A) Orders gazetted where a business income is specifically spelt out to be exempted at statutory income.

In the Income Tax (Allowance for Increased Export) Rules 1999 [PU(A) 128/99, 309/2003], a resident manufacturing company or agricultural company that exports manufactured products or agricultural produce in the basis period for a YA, is to be given an allowance for increased exports. The allowance will be given against 70% of statutory business income of the company. The amount set off is credited to an exempt income account, which is available to pay exempt dividends on a two-tier basis.

In the Income Tax Exemption on Export [Income Tax (Exemption) (No. 17) Order 2005, PU(A) 158/2005], a resident manufacturing or agricultural company that exports its product qualifies for income tax exemption based on the value of increased export. The rate of exemption will be either:

Rate of the value of increased export	Criteria
30%	Significant increase in export, determined by the formula of at least 50% increase in export value
50%	Penetrated new markets, as determined by MATRADE
100%	Received export excellence award from MITI for achieving the highest increase in export sales for a YA.

The exemption is based on 70% statutory income of business.

In the Malaysian International Trading Company (MITC) [Income Tax (Exemption) (No 12) Order 2002 PU(A) 60/2002, PU(A) 181/2003], the Malaysian Government wishes to assist the local manufacturers and farmers to expand their market share overseas to increase the country's foreign reserve and expand domestic growth. Incentive is given to MITC to help these manufacturers or farmers to export their products and commodities.

The exemption is based on statutory income. If the 70% statutory income is not sufficient to set off the incentive amount, the unabsorbed incentive amount can be carried forward to next year of assessment, setting off against 70% of statutory income until the incentive amount is fully credited into exempt income account.

Apportionment formula

The Act assesses individual source of income till statutory income before it is aggregated to form aggregate income. Where an expense is common between business 1 and 2, the Court of Appeal in *Ketua Pengarah Hasil Dalam Negeri v Daya Leasing Sdn Bhd*⁷ held that such common expenses are to be apportioned between business 1 and 2 based on gross income.⁸

Since the Court of Appeal held that the s 127 exemption is to be based on chargeable income, the business income although is exempted, has to be included in the tax computation and aggregated with the dividend income. An approved donation would be deducted against the aggregate income to arrive at chargeable income. Thereafter the chargeable income would be apportioned based on *Daya Leasing's* decision into exempt and non exempt portion.

7 [2005] 2 CLJ 449, CA.

8 For a detailed discussion of the *Daya Leasing* decisions, see Choong Kwai Fatt, *Advanced Malaysian Taxation*, 11th edn (Kuala Lumpur: Infoworld, 2009), pp 236–240.

With greatest due respect, the apportionment formula propounded in this case found no support from the Act. Parliament in its wisdom could not have omitted a provision for apportionment if the legislature wished to apportion chargeable income into exempt or non exempt portion.

Lord Donovan in *Mangin v Inland Revenue Commissioner*⁹ held that:

the object of the construction of a statute being to ascertain the will of the legislature, it may be presumed that neither injustice or absurdity was intended.

One cannot help thinking that there do exist injustice and absurdity if the above apportionment formula is to be accepted as the law applies to the Act. The taxpayer ended up paying additional RM4.7 million tax to the Government which was clearly a grossly injustice to them. In addition to that, the ratio of this case has far reaching effects. Other taxpayers may now have to incur additional compliance cost to include the exempt income into the computation and later apply the apportionment formula to exclude it again.

Lord Donovan in *Mangin's* case lays down two propositions in relation to statute interpretation. His lordship held:

The object of the construction of a statute being to ascertain the will of the legislature, it may be presumed that neither injustice nor absurdity was intended. If therefore a literal interpretation would produce such a result, and the language admits of an interpretation which would avoid it, then such an interpretation may be adopted.

The history of an enactment and the reasons which led to its being passed may be used as an aid to its construction.

In a recent Federal Court decision of *Sri Bangunan Sdn Bhd v Majlis Perbandaran Pulau Pinang & Anor*,¹⁰ NiK Hashim Rahman FCJ held that the duty of the court in construing a statute is limited to interpreting the words used by the legislature and to give effect to the words used by it. The court is not entitled to read words into a statute unless clear reason for it is to be found in the statute itself.

In *NKM Holdings Sdn Bhd v Pan Malaysia Wood Bhd*¹¹ Seah SCJ delivering the judgment of the then Supreme Court reminded the judges:¹²

It must always be borne in mind that we are judges, not legislators. The constitutional function of the courts is not only to interpret but also to enforce the laws enacted by Parliament. In enforcing the law we must be the first to

9 [1971] AC 739; [1971] 1 All ER 179, PC.

10 [2007] 5 AMR 541.

11 [1987] 1 MLJ 19, SC.

12 Ibid, at 22-23.

obey it. It should be noted that the power of a court to proceed in a particular course of administering justice, was one of substance and not merely of form. The duty of the court, and its only duty, is to expound the language of Act in accordance with the settled rules of construction. The court has nothing to do with the policy of any Act which it may be called upon to interpret. That may be a matter for private judgment. It seems to us to be unwise as it is unprofitable to cavil at the policy of an Act of Parliament, or to pass a court censure on the legislature.

The case of *NKM Holdings Sdn Bhd*, was referred to by Augustine Paul FCJ in the recent case of *Metramac Corporation Sdn Bhd (formerly known as Syarikat Teratai KG Sdn Bhd) v Fauziah Holdings Sdn Bhd*¹³ where the lordship said:¹⁴

...when the language used in a statute is clear effect must be given to it. As Higgins J said in *Amalgamated Society of Engineers v Adelaide Steamship Co Ltd* (1920) 28 CLR 129 at 161–162:

The fundamental rule of interpretation, to which all others are subordinate, is that a statute is to be expounded according to the intent of the Parliament that made it, and that intention has to be found by an examination of the language used in the statute as a whole. The question is, what does the language mean; and when we find what the language means in its ordinary and natural sense it is our duty to obey that meaning even if we think the result to be inconvenient, impolite or improbable.

In summary, the primary duty of the court is to give effect to the intention of the legislature as expressed in the words used by it and no outside consideration can be called in aid to find another intention. Thus the duty of the court, and its only duty, is to expound the language of a statute in accordance with the settled rules of construction. The very intention and objective of the Act is to compute income tax. To include an exempted income into the computation and later exclude it out again clearly violates the very object of the Act and not giving effect to the intent of the Parliament.

Conclusion

The fundamental corner stone of the Act is to impose tax on income. Where the Minister has provided an exemption on income, it provides certainty that such exemption must be operative from the beginning and be excluded from the computation of income tax. This is enshrined in s 127(5) that such exemption must be disregarded from the operation of the Act. It is thus to be exempted from gross income level. With such exemption on “gross” income, there is no requirement to exercise an arbitrary apportionment formula and a harmonisation of interpretation can be achieved.

13 [2006] 4 MLJ 113, FC.

14 Ibid at 129.