

AN ANATOMY ON INCORRECT RETURN AND ITS RELATION TO TAX AUDIT

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INTRODUCTION

Since the inception of self assessment for companies in the 2001 year of assessment ('YA'), the incorrect return penalty seems to be the shadow of tax audit. A penalty ranging from 45%–100% is imposed when an additional assessment (Form JA) is issued in relation to a year of assessment. The taxpayer in many occasions has challenged the validity of such imposition of penalty through tax appeal to the special commissioners, and the High Court. This article aims to analyse in depth the legislation and the case precedents on incorrect returns, the penalty and its relation to tax audit.

THE LEGISLATION

Section 113 of the Income Tax Act 1967 ('the Act') relates to incorrect returns. It sets up the scope of incorrect returns being:

- (a) omitting or understating any income; or
- (b) giving incorrect information in relation to chargeability.

Section 113 offences cover situation where the taxpayer has unintentionally computed his income taxes resulting in a lower amount of income tax being paid. This is due to his inability to understand the income assessability and deductibility of expenses. These are the lesser degree of offences as compared to s 114 of wilful evasion. Section 113 attracts a penalty fine but not imprisonment. To expedite the collection and to mitigate tax litigation in court, s 113(2) empowers the Inland Revenue Board ('IRB') to exercise its discretion in imposing penalties in addition to the tax undercharged arising from the incorrect tax return submitted.

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Section 113 has two limbs. The first limb in s 113(1) covers prosecution in court and empowers the court to impose a fine and penalty; whereas s 113(2) on the other hand, empowers the director general discretion to impose a penalty if the case is not being prosecuted in court under s 113(1). In both situations pertaining to s 113(1) or (2), the taxpayer is required to pay additional tax on any tax undercharged arising from the incorrect tax return submitted.

Section 113(1) clearly states that in the event that the taxpayer can satisfy the court that such incorrect return or incorrect information was made or given in good faith, then no penalty would be imposed. However, such wording of 'good faith' was missed out in s 113(2) and the complete absence of such wording would raise suspicions on whether such a defence of good faith is indeed available, or otherwise.

The Inland Revenue Counsel are of the opinion that with the legislation being what it is, one should employ the literal interpretation. Since s 113(1) employs the word 'good faith' and is missed out in s 113(2), then one cannot import such a defence of 'good faith' into the reading of s 113(2). This interpretation has gained support in the recent High Court decision of *Ketua Pengarah HDN v NV Alliance Sdn Bhd* [2010] MSTC 30-015 where Dato Aziah Ali J held on p 7,102 as follows:

I agree with the appellant (IRB) that 'good faith' is not a defence under s 113(2) of the Act. Therefore the penalty imposed by the Director General in the exercise of the discretion conferred by s 113(2) is correct.

With the greatest respect, the author begs to differ with this view. Section 113(1) and (2) must never be read in isolation. It has to be read as a whole. The taxpayer submits its tax return to the IRB with the assistance of a tax agent. It must have submitted in good faith with full compliance to the Act. Therefore, good faith must be used in both cases to determine the justification to impose a penalty bearing in mind that the imposition of a penalty is an offence. The taxpayer must be given the opportunity to mitigate such an offence.

Upon completion of a tax audit, the IRB would impose a penalty of 45%–100% on the tax undercharged under s 113(2) if the tax audit personnel are of the opinion that an incorrect return has been filed. Additional assessments (Form JA) would be issued to recoup the tax undercharge and the penalty.

The IRB has the discretion on deciding whether the taxpayer should be prosecuted when relying on s 113(1). It is never a decision of the taxpayer. If the taxpayer is permitted to apply 'good faith' as a defence only in prosecution case

as stipulated in s 113(1) but not able to do so in s 113(2) offences, it would somewhat prejudice him as he is being charged however not able to adduce defence of good faith. After all, whether he is to be prosecuted under s 113(1) or (2) is an entire discretion of the IRB. In any case, the taxpayer would naturally adduce evidence to convince the IRB or the court that the tax return was submitted in good faith ie that the taxpayer had no intention to defraud the government and had honestly believed that the returns which he submitted complied with the Act in order to appeal for a waiver of the penalty.

The originate jurisdiction of tax appeal lies in the hands of the Special Commissioners by virtue of s 102 of the Income Tax Act 1967. Schedule 5 of the said Act further provides the procedures of appeal. Since s 96(a) of the Courts of Judicature Act 1964 only permits the Federal Court to hear appeal from the Court of Appeal provided the original jurisdiction is at High Court; thus one would conclude that the final court for tax matters would be the Court of Appeal.

If the contention that good faith is only available in s 113(1) through prosecution, this would encourage more litigation through court procedure and not through negotiation with the IRB which is never the intention of any legislation, more so with the Income Tax Act. The Parliament enacted s 113(2) to encourage settlement without litigation in court. Since s 113(2) permits the IRB to impose a penalty in lieu of prosecution in s 113(1), it would then naturally allow the defence of good faith in s 113(1) to be applied mutatis mutandis in s 113(2).

AMBIGUITY IN THE ACT

The rule of interpretation of an act is to produce a harmonious result as intended by the Parliament. If one interprets s 113(1) and 113(2) in isolation, one cannot help to consider that such interpretation in s 113(2) creates injustice, being a criminal offence without allowing the plea of defence of good faith. This produces an absurd result.

The Income Tax Act imposes liability on the taxpayer. The canon of interpretation that applies to the ambiguity of the legislation is that the ambiguity must be resolved in favour of the taxpayer.

Lord President Hope held in *Glenrothes Development Corp v Inland Revenue Commissioners* [1994] Simon Tax Cases 74 at p 80 as follows:

But if there is an ambiguity, because the phrase in question is capable of two or more alternative meanings, the ambiguity will be resolved in favour of the taxpayer without regard to the question on whether it was appropriate for a tax to be imposed.

The court when construing a legislation which is ambiguous must then construe it according to the intention expressed in the Act itself. The function of the court is to interpret an Act 'according to the language used' (per Lord Parker CJ in *Capper and another v Baldwin* [1965] 2 QB 53 at p 61). In short, the duty of the court is to ascertain and give effect to the will of Parliament as expressed in the enactments.

In conclusion, allowing 'good faith' as a defence in s 113(2) produces harmony in the interpretation and consistency of the legislative intention.

THE IMPOSITION OF PENALTY

The imposition of a penalty aims to deter non-compliance and to ensure that all taxpayers pay their legally due tax to the government. It discourages the submission of incorrect tax returns. Since the object of the tax audit is to encourage voluntary compliance and to educate the taxpayer, the IRB should invoke s 113 where there is clear evidence of incorrect returns being submitted. The Act imposes income tax provided the receipt is income in nature. Capital gains are free from income tax and excluded from the tax return computation. The taxpayer with the assistance of tax specialist have to exercise judgement to ascertain whether a receipt is income or capital gains. Therefore, it is felt that if taxpayer has exercised good faith in concluding that a receipt is capital gain of which later it may be disputed with tax authorities, he can not be liable for filing an incorrect return.

The Income Tax Act is never an easy piece of legislation to understand. It involves an appreciation of accounting principles, evolves into various concept of income starting from gross income, adjusted income, statutory income, aggregate income, defined aggregate income, total income to chargeable income. The courts, in many instances have differed in opinion when asked to pronounce an opinion or give effect on a particular section. The computation of tax in any year of assessment involves the facts and the application of the Act on the facts, namely on the question of facts and of law. If the taxpayer has interpreted an act on good faith which is later not accepted by the IRB during the tax audit, the adjudication is determined by special commissioners and the court. Such an issue should not be classified as an incorrect return. Section 113 has no application. This is to encourage the development of law in this country as well as to avoid unduly penalising the taxpayer when undertaking bona fide business decisions. The common examples on the question of law would be the scope of bad debts in s 34(2) and entertainment expenses in s 39(1)(l). The deduction of promotional expenses; whether the disposal of land is to be

treated as capital gain, free from income tax is also an example of question of law which is to be determined by court when there is a dispute between taxpayers and the IRB.

Upon completion of the tax audit at the taxpayer's premises, the IRB would then conclude that either:

- (a) the income was understated;
- (b) the expenses were over-claimed; or
- (c) the double deduction of expenses was not available;

and impose a penalty of 45%–100% on the additional tax, under s 113(2) on the submission of incorrect returns.

The taxpayer, on the other hand may contend that either:

- (a) the profit was not income but instead a capital gain;
- (b) expenses were deductible under s 33(1) and not prohibited by s 39 of the Act; or
- (c) double deduction of expenses complied with the *gazette* orders (PU(A)) issued by the Ministry of Finance.

It is felt that where tax disputes involves question of law, penalty on incorrect return should not be imposed as the taxpayer he is merely complying to his responsibility in accordance to the Income Tax Act.

An appeal would be filed to the special commissioners by submitting Form Q. The tax court as well as the special commissioners are there to adjudicate the matter based on the Act.

In *Ketua Pengarah HDN v NV Alliance Sdn Bhd* [2009] AMTC 1242, the special commissioners held that the expenses/incentives paid to non-employees were promotional expenses and were deductible under s 33(1) of the Act. The High Court however overturned the decision and concurred with the IRB that such an expense was for entertainment purposes which is prohibited by s 39(1)(l). This case clearly highlights the difficulty of the interpretation of whether cash incentives paid to non-employees were promotional expenses (tax deductible) or entertainment expenses (not tax deductible). The special commissioners and the court, based on the same facts, arrived at different decisions.

In relation to the penalty on incorrect returns, the special commissioners in *NV Alliance Sdn Bhd* held that since the cash incentives were promotional

expenses wholly and exclusively incurred in the production of income and not prohibited by s 39(1)(l), the taxpayer thus submitted his returns correctly. Section 113(2) was therefore inapplicable and penalty was not an issue

The special commissioners went on to conclude that even these cash incentive expenses were not permissible. The taxpayer nonetheless exercised his interpretation in good faith; hence the penalty under s 113(2) should not be imposed. The special commissioners relied on the defence of good faith in s 113(1) to be read together with s 113(2) as the special commissioners interpret s 113 as a whole.

Ahmad Zaki b Husin opined on p 1,255 as follows:

Regarding the penalty under s 113(2) of the Act imposed on the Appellant in this case, we are of the opinion that the imposition of that penalty is wrong in law as even assuming that the expenses claimed are not allowable. Based on the facts of this case, the claim was made based on the Appellant's interpretation in good faith. Therefore the penalty shall not be imposed.

SPECIAL COMMISSIONERS' DECISION

The special commissioners have consistently read s 113 as a whole and allowed good faith as a defence when deciding on whether a penalty was appropriate in interpreting s 113(2). It is a trite principle that s 113 has no application ie no penalty to be imposed when the taxpayer succeeds in the appeal.

In *ELMSB v Ketua Pengarah HDN* [2009] AMTC 1224 the special commissioners held that the conference (congress expenses) paid to the medical doctor with the objective to promote the taxpayer's pharmaceutical products were revenue expenses and tax deductible; a penalty on incorrect returns was inapplicable.

Ahmad Zaki b Husin opined on p 1,241 as follows:

Finally, we agree with the appellant that this is only academic. If the issue on congress expenses is allowable, there was no incorrect return filed and no penalty should be imposed.

In a tax appeal before the special commissioners, the commissioners would segregate the merits of the tax issues and the imposition of penalty under incorrect return. After listening to the arguments from both counsel, the commissioners may rule that the taxpayer has lost its case. Such commissioners would go on to consider the validity of the IRB imposing such penalty. The issue to be determined in this regard is whether the taxpayer has submitted the

return incorrectly ie whether the taxpayer had acted in good faith when exercising an interpretation to be applied on the facts in issue. If he did, the penalty would not be applicable.

In *ELMSB v Ketua Pengarah HDN* [2009] AMTC 1224, the taxpayer who was involved in the trading of pharmaceutical products, claimed for congress expenses, sponsorship for doctors attending conferences, as a revenue expense under s 33(1) which was contended by the IRB personnel as submitting an incorrect return in deducting expenses which were not supposed to be deducted. As a result, he was imposed with a 60% penalty on the additional tax payable under s 113(2). In rebutting the allegation of the incorrect return, the taxpayer submitted that:

- (a) the IRB had in prior years, allowed the expenses;
- (b) the IRB was in possession of the facts and circumstances of the payment of congress expenses; and
- (c) the information was provided correctly to the IRB.

Therefore in such circumstances, the return cannot be described as an incorrect return. Good faith has been established. A penalty should not be imposed even if the expenses are not deductible as contended by the IRB being entertainment expenses.

In situation where the commissioners allows the appeal of the taxpayer, the taxpayer is said to have won its case. Then the penalty should not be imposed against the appellant. The special commissioner held on p 1,240 that:

On the penalty of 60% imposed under s 113 of the Act, which was on the incorrect return, the appellant submitted that the congress expenses was claimed as a deduction, with a line by line analysis, since such expenses were first incurred, which were always allowed and admitted and confirmed by AW1. The appellant maintained that the correct information was given to the respondent. Therefore, the respondent had allowed such congress expense in prior years; this led the appellant to claim the expenses.

The respondent submitted that the penalty was imposed on the ground that the appellant made incorrect returns in deducting certain expenses which were not supposed to be deducted. The appellant however submitted that the respondent had in prior years allowed the expenses and furthermore, the respondent was in possession of the facts and circumstances of the payment of congress expenses; in such circumstances, the return cannot be described as an incorrect return. We are of the view that based on the facts and circumstances of the case, the penalty should not be imposed against the appellant.

In *SPM Sdn Bhd v Ketua Pengarah HDN* [2008–2009] AMTC 1188, the special commissioners held that franchise fees based on sales was revenue expenditure and not capital expenditure as contended by the IRB. In relation to issue of penalty arising from incorrect returns, the special commissioners held that a penalty should not be imposed under s 113(2) as:

- (a) there was no evidence to show that the taxpayer had the intention to evade tax;
- (b) the taxpayer had not concealed the deduction of franchise fees; and
- (c) the taxpayer was fully co-operative during the tax audit.

With the greatest due respect, the reading of s 113(2) together with s 113(1) merely requires the taxpayer to demonstrate good faith to abate the penalty. Good faith is determined by the positive act of honest belief, that the taxpayer acted in bona fide. What is required from the taxpayer is for him to adduce evidence to show that he honestly believed that the deduction was available based on his best interpretation of the Act. The taxpayer is not required to adduce evidence that he had no intention to evade tax. If the taxpayer had attempted to evade tax, he would be charged under s 114 on 'wilful evasion'. In summary, tax evasion has to be distinguished from an incorrect return. The former is a severe offence which attracts imprisonment and three times tax penalty. Therefore, a taxpayer if found not committing the tax evasion, one cannot conclude that he has submitted the tax return correctly.

In this regard, the special commissioners propounded the three stage test in consideration of the penalty under s 113(2). Ahmad Zaki bin Husin held on p 1,198 as follows:

In regard to the question of penalty imposed by the respondent, in case our above finding is wrong, there is no evidence to show that the appellant had the intention to evade tax. The tax computation prepared by the appellant shows that the appellant has taken deductions for the franchise fee and there is nothing to suggest that the appellant has attempted to conceal the deductions. The appellant was fully cooperative during the tax audit by the respondent which resulted in the notice of assessment in question. Therefore we find that there is no justification to impose the penalty.

In *SSU Sdn Bhd v Ketua Pengarah HDN* [2008] AMTC 1067, the special commissioners found that the taxpayer had:

- (a) discrepancies in his offering of rebates and discounts; evidence revealed that the rebates were not provided to his customers; and
- (b) claimed provision of discount as tax deductible expenses.

This case justifies the imposition of a penalty on incorrect returns as there was evidence of concealment of income, over-claimed expenses and negligence of not paying the rebates to customers even after the deduction had been obtained. The special commissioners thus found that the penalty of 80% on tax undercharge was justifiable and that the IRB had the basis to exercise the discretion under s 113(2).

Ahmad Zaki bin Husin held on p 1,077 as follows:

In respect of the penalty imposed, we have to view whether the respondent has the right to impose, or otherwise. Under s 113(2) of the Act, the respondent is empowered to impose up to 100% penalty (a penalty equivalent to the amount of tax). This is the discretion of the respondent. Whether it is viewed as harsh or not, or whether it needs to differentiate between the technical adjustments or on the difference in the opinion is not material. Therefore, we find that the respondent has sufficient basis to impose the penalty at 80% and no reason for us to interfere.

In *BTN v Ketua Pengarah HDN* [2008] AMTC 079 the special commissioners held that the taxpayer had understated the income by not reporting the bad debts recovered. The taxpayer failed to declare the correct income in the tax computations. Thus the penalty was appropriate. However the special commissioners revised the penalty rate to 50% of tax undercharged as they found that the IRB had failed to apply 'his mind to the facts and circumstances of the case'.

Ahmad Zaki bin Husin held on p 1,086 as follows:

Regarding the penalty under s 113(2) of the Act, we agree with the respondent that the penalty was properly imposed because the amount of RM 593,598 written off and claimed as bad debts was recovered after the respondent conducted a field audit on the appellant on the 10 and 11 January 2005. It means that the appellant failed to declare the correct income in his tax computation submitted to the respondent for the Year of Assessment 1999. Since RW1 (the assessor) admitted that he just followed the guideline of the Director General of Inland Revenue on penalty, it means that RW1 did not apply his mind to the facts and circumstances of the case before imposing the 60% penalty. Therefore we are of the opinion that the respondent failed to use their discretion properly when they imposed the penalty concerned. We are of the view that a 50% penalty is justified on the facts and circumstances of the case. We therefore allow the appeal and the penalty shall be reduced to 50% of the tax payable for the year of assessment 1999.

CONCLUSION

The IRB technically can only exercise their discretion to impose the tax penalty in situation where there are clear evidence that the taxpayer indeed has intention or has exercised its computation of income tax without due care. Such tax penalty can range from 45%–100% of the tax undercharged. However, the IRB must exercise its discretion when taking into account the facts and merits of each case.

The Income Tax Act 1967 is not an easy piece of legislation to be understood by lawyers as it involves legal and accounting skills. Case precedents has in many instances illustrated that the learned judges do differ in opinion in the High Court and Court of Appeal when they were asked to interpret a section of the act based on the agreed facts. Therefore, it is submitted that when the tax disputes between the taxpayer and IRB involves a question of law, it is not within the ambit of s 113 . Penalty on incorrect return should never be imposed.