

Redefining Section 127(3A) as a Provision to Exempt Tax Liability

by S Saravana Kumar & Desmond Liew Zhi Hong

Recently, the High Court in *FTM Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* held that Section 127(3A) of the Income Tax Act 1967 ("ITA") does not empower the Minister of Finance ("Minister") and the Director General of Inland Revenue ("DGIR") to exclude a taxpayer from enjoying a tax incentive entitlement. In reversing the decision of the Special Commissioners of Income Tax ("SCIT"), the court held that Section 127(3A) is an enabling provision that exempts a taxpayer from tax liability rather than to exclude a taxpayer from enjoying a tax incentive.

Facts

The taxpayer is in the business of manufacturing and assembling of apparatus and component parts. As a manufacturer that exports manufactured products, the taxpayer desired to claim allowance for increased exports ("AIE") under the Income Tax (Allowance for Increased Exports) Rules 1990 [PU(A) 128/1999] ("the Rules").

As the tax incentive sum was substantial, the taxpayer, through its tax agent, wrote to the DGIR to seek concurrence that it was qualified to claim the AIE. The DGIR responded that the taxpayer had satisfied all the prescribed conditions under the Rules, and in principle, was eligible to enjoy the AIE. However, as the taxpayer did not incur a large part of the raw material costs for its manufacturing activity, the DGIR wanted to obtain a policy ruling from the Minister. The Minister then made the policy

ruling that the taxpayer was not eligible to claim the AIE as it did not incur the raw material costs. The taxpayer's appeal to the Minister was not entertained. Accordingly, in order to avoid any tax penalty, the taxpayer decided not to claim the AIE under protest and proceeded to lodge an appeal to the SCIT pursuant to Section 99(4) of the ITA.

Unfortunately, despite the SCIT's acknowledgment that the taxpayer had satisfied all the prescribed conditions to claim the AIE, the SCIT held that Section 127(3A) empowered the Minister to exclude the taxpayer from making such a claim. According to the SCIT, Section 127(3A) empowered the Minister to exclude applicability of any provision of the ITA and this includes provisions that grant tax incentives.

Taxpayer's appeal before High Court

Dissatisfied with the SCIT's decision, the taxpayer appealed to the High Court. The taxpayer argued that it was entitled to claim the AIE as it was not disputed that all the prescribed conditions under the Rules had been satisfied. Among others, the products exported attained at least 50% of the percentage of value added.

The only circumstances where one cannot claim the AIE are stipulated in Rule 8 of the Rules, namely, if a taxpayer had been granted any incentives under the Promotion of Investments Act 1986 ("PIA") or claimed reinvestment allowance. In the *FTM* case, it was a proven fact that the taxpayer was not awarded any incentives under the PIA or claimed reinvestment allowance. Disappointingly, this fact was ignored by the SCIT.

Further, the Minister's policy ruling that the taxpayer must incur the raw material costs for the manufacturing activity was nowhere to be found in the Rules or the ITA.

Additionally, the SCIT had misinterpreted Section 127(3A), which reads:

“The **Minister may**, in any particular case **exempt any person from all or any of the provision** of this Act, **either generally or in respect of any income** of a particular kind or any class of income of a particular kind.” (*Emphasis added.*)

The statutory interpretation rules require Section 127(3A) to be read as a whole and not disjunctively without having regard to the second limb of the section. The SCIT cannot interpret Section 127(3A) to the own favour by disregarding the second limb of the provision, which clearly states that the exemption must be in respect of any income rather than a tax incentive.

The High Court accepted the taxpayer’s argument that Section 127(3A) is an enabling provision, whereby it confers power on the Minister to exempt any person from a tax liability rather than to exclude a taxpayer from enjoying a tax benefit like the AIE. This position is substantiated by the Explanatory Notes to the Finance Bill 2005, which introduced Section 127(3A). It clearly reflected Parliament’s intention to empower the Minister to exempt any person in respect of any income or class of income from tax under the ITA. However, by misinterpreting Section 127(3A), the SCIT did not promote Parliament’s intention in introducing Section 127(3A).

Our views

This is the first landmark case to have examined the scope of Section 127(3A) and the limit of the Minister’s power in applying the said provision. It demonstrates the arbitrariness of the Minister and the DGIR’s power in denying the taxpayer’s right to claim the AIE merely because the tax incentive sum was substantial. Fortunately, the High Court set aside the SCIT’s decision. Had it been otherwise, it would have defeated the government’s

objective in introducing the AIE. Although the DGIR appealed to the Court of Appeal against the High Court’s decision, the DGIR recently withdrew its appeal.

On a separate note, the case also exemplifies how Section 127(3A) grants a wide discretion to the Minister and the need to immediately reform this aspect of the Minister’s power. Further, there is no need for Section 127(3A) as Section 127(3) provides the Minister the same discretion to grant tax exemption, but with a safeguard through Section 127(5) in which he is required to gazette the tax exemptions that he granted. Gazetting such tax exemptions contributes to a more transparent tax administration in Malaysia.

LH-AG

About the authors



S Saravana Kumar (sks@lh-ag.com) is a partner with the Tax, SST & Customs Practice. He is described by clients as “extremely innovative in his interpretation of laws” and is “committed, sound in knowledge, amiable and always well prepared”. He regularly represents taxpayers on various direct and indirect tax disputes before the Malaysian courts. Recently, Saravana was recognised by Thomson Reuters’ Asian Legal Business as one of the top 40 lawyers in Asia under the age of 40.



Pupil Desmond Liew Zhi Hong, also with the Tax, SST & Customs Practice, is a holder of Bachelor of Laws (First Class) from the University of London and Bachelor of Taxation (First Class) from Universiti Tun Abdul Razak (UniRazak). He assisted Saravana in the *FTM* case at the High Court and the Court of Appeal.