

**THE SCOPE OF “ADVENTURE IN THE NATURE OF TRADE”**

**AND ITS IMPACT ON**

***AL-BAY‘ BITHAMAN AJIL* TRANSACTIONS**

**By**

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## ABSTRACT

Malaysian Income Tax Act 1967 imposes income tax on any transaction that give rise to profit, which is “income “ in nature. Capital gains fall outside of the ambit of income tax. It is therefore important to distinguish between “income” or “capital” transaction.

One of the examples of “income” transaction is the “adventure or concern in the nature of trade”. This meaning however is not defined in the Act and its’ scope can only be explored through the examination of case laws. The acid test is “Badges of trade”.

The application of “badges of trade” on landed transaction is not the same as the non-landed transactions. The boundaries can be explored by analysis of the Malaysian case laws. However, this common law test is not suitable on Islamic product particularly the *Al-Bay<sup>c</sup> Bithaman Ājil* transactions (BBA).

*Al-Bay<sup>c</sup> Bithaman Ājil* is an important Islamic instrument for asset financing. To promote such product as to avoid *Ribā*, one has to be certain of its’ income tax exposure on BBA transactions. The existing practice using the common law’s badges of trade to ascertain the tax liability of BBA transactions may result in unfairness and a tendency of collecting higher income tax.

The Government should therefore take steps to codify the taxability of BBA transactions to make it equitable, transparent and certain.

## ملخص الجث

يفرض القانون الضريبي بماليزيا السنة ١٩٦٧ ضريبة الدخل على أية معاملة تجارية التي تكسب الربح أو الفائدة، والتي في الحقيقة هو "الدخل". أما رأس مال فهو يقع في خارج نطاق ضريبة الدخل. لذلك من المهم التفريق بين المعاملة التجارية المتعلقة برأس مال وبين المعاملة التجارية المتعلقة بالدخل.

ومن احدى النماذج للمعاملة التجارية المتعلقة بالدخل هي مجازفة مالية أو الاهتمام في التجارة. رغم ذلك، هذا المدلول لا يكون موضحا ومعرفا ضمن القانون، ويستكف مجاله من خلال دراسة نقدية في نظام السوابة. أما القانون المستمد في هذه القضية هي "شارات تجارية".

واستعمال شارات تجارية في التجارة الأرضية وفي التجارة غير الأرضية فمختلف ومتغير. وتلك الحدود والاختلافات مكشوفة نتيجة دراسة تحليلية على القانون المستمد الماليزي، رغم ذلك، إجراء هذه التجربة القانونية العادية على أنواع المعاملات الاسلامية غير مناسب، وبخاصة البيع بثمن آجل.

إن البيع بثمن آجل يعد من أهم وسائل تجارة الموجودات والعقارات. وفي صدر التشجيع على هذه المعاملة تبطيلاً للربا، يجب علينا مراعاة وتأكد من مدى تعرض هذه المعاملة على ضريبة الدخل. فضلا عن ذلك، ان التجربة المطبقة حالياً التي تستخدم شارات تجارية قانونية عادية في سبل التأكد على احتمال فرض ضريبة الدخل على البيع بثمن آجل، ستقضي إلى عدم الانصاف في جمع الضريبة.

لذلك، ان الحكومة مسؤولة على اتخاذ القرارات والاجراءات المناسبة لتنظيم وتنسيق الضريبة في البيع بثمن آجل لتكون هذه المعاملة منصفة وواضحة وموثوقة.

## APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standard of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Comparative Law.



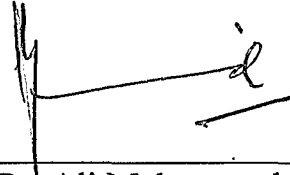
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Professor Dr. Hj Razali Nawawi

Supervisor

Date: MAY 16 2000

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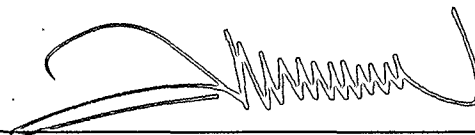
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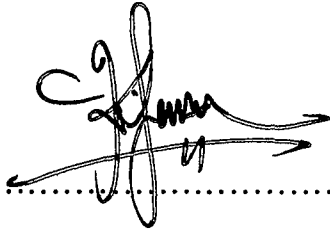
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## DECLARATION

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and a bibliography is appended.

Name: Choong Kwai Fatt

Signature .....

A handwritten signature in black ink, appearing to be 'Choong Kwai Fatt', written over a dotted line. The signature is stylized with loops and a long horizontal stroke at the end.

Date: 14 May 2000

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May Allāh bless all of you.

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# CHAPTER 1: INTRODUCTION

## 1.1 Objectives of the study

Malaysian Income Tax Act 1967 imposes income tax on transactions that give rise to profit, which is “income” in nature. Capital gains fall outside the ambit of income tax. It is therefore important to distinguish between “income” or “capital” transaction.

The taxability on an isolated transaction add more to the confusion as in some cases the court decided that it was “income’ in nature thus subject to income tax while in other instances the court held that the transaction is of capital gain. This is mainly due to the opinion of judges whether such transactions fall into the ambit of “adventure or concern in the nature of trade”<sup>1</sup>.

A transaction that falls into the ambit of “adventure in the nature of trade” would be subject to Malaysian income tax and be assessable under section 4(a) of the said Act. However, the meaning of “adventure or concern in the nature of trade” is not defined in the Act and can be understood only through case law decisions. The objective of the study is to examine the scope of “adventure in the nature of trade” by analyzing the Malaysian and English decided cases.

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<sup>1</sup> Section 2 of the Malaysian Income Tax Act 1967, definition of business.

*Al-Bay' Bithaman Ājil* (BBA) is an important Islamic instrument for asset financing. The issue of whether the gain on disposal of asset financed under BBA attracts income tax is never certain. It is hoped that the study of the boundaries of “adventure in the nature of trade” will assist in determination of taxability on BBA transactions.

## **1.2 Summary of the Proposed Thesis**

Chapter 1 will consist of an introduction to the chapter generally. The objectives of the study, its scope, the hypothesis and methodology used for this research are highlighted. The importance of the subject and the reason of the study will also be discussed. Here, the scope of “Adventure in the nature of trade “ is examined and the impact on BBA is also explored.

Chapter 2 will discuss the elements of badges of trade in general. References are made to the Malaysian cases to examine the use and scope of each badge of trade. This will be the acid test to determine whether a particular transaction falls under the ambit of an adventure in the nature of trade.

Chapter 3 proceeds to analyze the application of badges of trade into the scope of “adventure in the nature of trade” in relation to **landed property transactions**.

Chapter 4 analyzes the application of badges of trade into the scope of “adventure in the nature of trade” in relation to **non-landed property transactions**.

Chapter 5 will first examine the fundamental Islamic principles relating to transactions, as described in the Holy Qur'ān and Shari'ah. Emphasis would also be placed on the prohibition of interest (*ribā*) in an Islamic environment and its rationale.

In Malaysia, BBA has been commonly used as a mode of asset financing to avoid *ribā*. Its *modus operandi* and its mechanism would be discussed. It is hoped to highlight the usefulness and limitation of BBA in the modern days for asset financing.

Chapter 6 will combine the findings found in Chapter 3 and 4 and then analyze the impact of badges of trade (a test used to determine adventure in the nature of trade) on BBA transactions. If the Islamic mode of financing is within the ambit of "adventure in the nature of trade", then the tax factor should be considered when implementing such Islamic Instruments.

Chapter 7 will suggest an amendment to the Income Tax Act to provide certainty as to the application of badges of trade (to ascertain adventure in the nature of trade) on the asset financed under BBA.

## **1.3 Hypothesis**

### **1.3.1 Is the “badges of trade test” the sole-determining factor for adventure in the nature of trade?**

Traditionally, badges of trade has been used to determine whether a transaction falls into adventure in the nature of trade. This has been established through the study of case law decisions from commonwealth countries including the United Kingdom.

A comprehensive analysis of the Malaysian case law from 1932 – 1998 will be carried out to establish whether Malaysian judiciary would decide the issue of “adventure in the nature of trade” solely on badges of trade or has introduced other additional elements.

### **1.3.2 What is the minimum number of badges of trade to be required in order a transaction to be subject to Income Tax?**

Once a transaction falls into the ambit of adventure in the nature of trade, it would then be subject to income tax. However, there are nine main elements of badges of trade and it is hoped that the research can establish the minimum number of badges of trade required to establish the element of “adventure in the nature of trade”.

### **1.3.3 Is there a requirement to draft a separate section for BBA transactions?**

The existing provisions of the Malaysian Income Tax Act 1967 would not be appropriate and adequate to assess the taxability of Islamic transactions, particularly BBA. It is therefore hoped that the research can offer an amendment to the Act.

## **1.4 Methodology**

This research is based on doctrinal approach. It will be on library research.

## **1.5 Scope**

1.5.1 An examination of Malaysian case laws reported in Malayan Law Journal, Current Law Journal and All Malaysian Report will be carried out.

## **1.6 Organization of Chapters**

Chapter 1: Introduction

Chapter 2: Badges of trade

Chapter 3: The applications to landed property transactions

Chapter 4: The applications to non landed property transactions

Chapter 5: The *modus operandi* of BBA

Chapter 6: The Impact of badges of trade on BBA transactions

Chapter 7: Conclusion

## **1.7 Limitation of the Research**

This research confine to Malaysian case law decided from 1932 – 1998. These cases may not be exhaustive and thus the scope of adventure in the nature of trade may be restrictedly defined.

The *modus operandi* of BBA may differ from country to country. The research will only focus on Malaysia practices. Nonetheless, this research would be relevant to show the relationship between BBA with Malaysian Income Tax Act 1967.

## **CHAPTER 2: BADGES OF TRADE**

### **2.1 Introduction**

The acid test laid down by the Court to decide whether a transaction falls into the ambit of “adventure or concern in the nature of trade” is the “Badges of trade”. It is interesting to note that both the taxpayer and the tax authorities rely on the same test for their assertion respectively.

The taxpayers use “badges of trade” to argue that a particular transaction is of capital gain (long term investment) thus no income tax. The tax authorities on the other side would use the same badges of trade arguing that such a transaction is “adventure or concern in the nature of trade” (short term investment) thus subject to income tax. In general, it is the total effect of all-relevant factors and circumstances that determine the character of the transaction, whether “income” or “capital” in nature.

“Badges of trade” can be compartmentalized into nine (9) items. If both the disputing parties namely the taxpayer and the tax authorities cannot come to an agreement, the issues would have to be resolved by the Special commissioners and the Courts. It should be noted that the emphasis placed on the items of “Badges of trade” varies, depending on the merit of each case.



## 2.2 Subject matter of the transactions

Where the subject matter itself produces “income” by holding it or it does give rise to personal enjoyment, the subject matter will be treated as long term investment. The disposal of such subject matter would not be subject to income tax as it is capital in nature.

On the contrary, if the subject matter is the trading subject and rarely the subject of investments and is more likely to have been acquired for the purpose of resale at a profit, it results in a trading activity giving rise to profits chargeable to income tax.

Edgar Joseph Jr SCJ opined at p.741 in *Lower Perak Co-operative Housing Society Bhd v Director General of Inland Revenue*<sup>2</sup>

“Then, again in considering the question whether there has been an intention to trade, a factor to which regard may be had is the nature of the subject matter in question; more particularly, whether the subject is prima facie an investment. Thus, in *Commissioners of Inland Revenue v. Reinhold* 34 TC 389 at p.393, Lord Carmont said this:

‘A disclosed intention not to hold what was being bought might, as Lord *Dunedin* said, provide an item of evidence that the buyer intended to trade and if the commodity purchased in the single transaction was not of a kind normally used for investment but for trading and if the commodity could not produce an annual return by retention in the hands of the purchaser, then the conclusion may easily be reached that the adventure was a trading one. If, however, the subject matter of the transaction is normally used for investment - land, houses, stocks and shares - the inference is not so readily to be drawn from an admitted intention in regard to a single

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<sup>2</sup> [1994] 2 MLJ 713 (FC)

transaction to sell on the arrival of a suitable pre-selected time or circumstances and does not warrant the same definite conclusion as regards trading or even that the transaction is in the nature of trade’.”

### 2.3 Period of ownership

Generally, the longer the period of ownership of the subject matter before its disposal, the more likely that such disposal would be considered as disposal of long term investment. The retention of a property for a period followed by its subsequent sale does not preclude the profits from being treated as a trading receipt.<sup>3</sup> One must consider other badges of trade as well.

However, the term’s “short period” and “long period” are not defined in the Act or case laws. The period is a relative one. In recent years, the Malaysian court even went on to rule that a period of five years does not necessarily reinforce the investment motive.

It is a settled law that in the case of a company incorporated for the purpose of making profits for its shareholders any gainful use to which it puts any of its assets prima facie amounts to the carrying on of a business.<sup>4</sup>

As such, a company may hold a property for a long period of time; any subsequent disposal may still be viewed as business income because they may be viewed as waiting for the right opportunity to realize profits.

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<sup>3</sup> *ME (Pte) Ltd v CIT* [1987] 2 MLJ 130 (HC)

<sup>4</sup> *ALB Co Sdn Bhd v DGIR* [1978] 1 MLJ 1 (PC)

Raja Azlan Shah F.J. (as His Royal Highness then was) said in *I Investment Ltd v. CGIR*<sup>5</sup>:

“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 right opportunity to occur.”

## 2.4 Frequency of transactions

If there had been a number of transactions of the same kind, (a repetition of transactions) it may be presumed that the taxpayer’s purpose in purchasing the particular property was to resale at a profit.

However, a single or isolated transaction can also constitute trading. [*International Investment Ltd v CGIR*<sup>6</sup> Viscount Dilhorne observed:

“a company whose business is or includes trading prima facie begins to trade as soon as it embarks upon the first transaction of a trading nature. The transaction in this case could therefore constitute trading even if it was isolated”.

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<sup>5</sup> [1975] 2 MLJ 208 at 212 - 213

<sup>6</sup> [1979] 1 MLJ 4 (PC)

It should be noted it would be easier to establish trading intention in the case of company as compare to an individual because the object of the company is to make profits for its shareholders.

There need not be many purchases to constitute trading. One purchase of large quantity of shares, property, commodity or anything can be for the purpose of a business or an adventure in the nature of trade.

## **2.5 Alterations to the property**

The fact that material alterations or improvements have been made on to property acquired or that its character or quality has been changed so as to render it more merchantable would tend to indicate that the property was acquired for a profit-making undertaking or scheme.

However, if the property was clearly acquired for other purposes, extensive activities to render it more saleable after it is no longer useful for such original purposes would not cause any selling profit to be taxable<sup>7</sup>.

In the case of land, when the taxpayer took step to subdivide the land or convert the land from agriculture use to commercial use, such an action would be viewed by the tax authorities as a step into or adventure in property trading.

## 2.6 Circumstances responsible for the realization

The circumstances under which the subject matter is disposed of may be relevant as to whether such a disposal is part of a trading transaction. If the sale of property is occasioned by sudden emergency or unanticipated need for funds, such facts will tend to indicate that the property was not acquired for the purpose of resale at a profit and that the sale was not pursuant to a profit-making scheme or undertaking.

One has to ask whether the taxpayer disposed of the property because he was hard pressed for funds or whether he was presented with an opportunity to sell at a profit and hence proceeded to do so.

Edger Joseph Jr SCJ said in *Lower Perak Co-operative Housing Society Bhd v DGIR*<sup>8</sup>;

“The circumstances necessitating the realization of an asset may be of prime importance as it may afford an explanation for the realization that negatives the idea that any plan of dealing motivated the original purchase”.

According to the general income tax law, sale must be consensual and of one's own free will before the proceeds can be chargeable to income tax. A forced sale cannot constitute a sale the proceeds of which are not subject to tax because the element of compulsion vitiates the intention to trade.

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<sup>7</sup> *NYF Realty Sdn Bhd v CIR* [1974] 1 MLJ 182 (HC)

## 2.7 Motive/Intention of taxpayer

A good test to determine whether the subject matter held is investment or “adventure in the nature of trade” is to establish the intention of the taxpayer at the time of acquisition of such subject matter.

Thus where the subject matter was acquired with the underlying purpose of profit making, the profits from the realization thereof will be treated as “income” in nature. There must be a sole or main object of realizing a gain, which must exist at the time of acquisition of the subject matter. The conduct of the taxpayer *vis-à-vis* the subject matter would have to be examined to discover his true intent at the time of acquisition.<sup>9</sup>

It should be noted that a permanent investment might be sold in order to acquire another investment thought to be more satisfactory that does not involve an intention of trade whether the first investment is sold at a profit or at a loss.

## 2.8 Methods employed in disposing of property

If special exertion is made to find or attract purchasers such as the opening up of an office, advertising extensively, such facts will indicate the presence of a profit making undertaking.

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<sup>8</sup> [1994] 2 MLJ 713 (FC)

<sup>9</sup> See *Bukit Yew Sdn Bhd v DGIR* [1987] 2 MLJ 379 (HC)

However, such facts would not of themselves cause the profit to be taxable if the original purpose in acquiring the property was to use it or to hold a long term investment rather than to resell it at a profit.

In *KLE Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri*<sup>10</sup>, the Special Commissioners held that the subject land's commercial potential together with its good location, being near developed areas was a very good ready-made advertisement in itself. Therefore there was no necessity to have a specialized organization with skilled staff, and there was no further exertion needed to promote its resale.

## 2.9 Financing arrangements

The mode of finance placed great importance in determining whether the taxpayer is trading in property or merely realizing its investment. If a company had the intention to hold the property as a long-term investment, then the company should inject more fund into the company instead of borrowed funds.<sup>11</sup>

However, it is by no means determinative. It depends on the facts of each case. In *Lim Foo Yong Sdn Bhd v CGIR*<sup>12</sup>, the asset was held to be an investment though it was financed by borrowed money.

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<sup>10</sup> [1995] 2 MSTC 2245 (Sp Comm)

<sup>11</sup> *SCL Pte Ltd v CIT* [1991] 1 MSTC 5032 (HC) (Singapore)

<sup>12</sup> [1980] 2 MLJ 161 (PC)

## 2.10 Accounting evidence

It is settled law that accounting evidence is not conclusive as to whether the taxpayer is trading or not, it being merely a factor to be taken into consideration.<sup>13</sup>

The fact that if property is categorized as fixed asset is acceptable evidence of the intention of the taxpayer to treat it as capital asset instead of trading asset. A trading asset would be entered under "Current Asset". Sale of a fixed asset does not attract income tax.<sup>14</sup>

## 2.11 Conclusion

The question whether the taxpayer is venturing in "adventure or concern in the nature of trade" or merely realizing a long term investment is a question of fact to be decided after taking into account all the above badges of trade. There can never be two cases of the same fact. To decide on the issues, it is the total effect of the badges of trade and thus it has to be decided on its own merits.

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<sup>13</sup> *CGIR v LFY Sdn Bhd* (1983) 1 MLJ 43

<sup>14</sup> *DGIR v Khoo Ewe Aik Realty* (1990) 3 MTC 149 (HC)