Chapter 7

Business Income

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Introduction

The owner of the business will be taxed on his income from Section 4(a) to 4(f) (if any) using a scheduler tax rate. However for companies, the business income will be taxed on a flat tax rate of 28%.
Definition of Business

- Section 2 of the Act defines business to include profession, vocation and trade and every manufacture, adventure or concern in the nature of trade but excludes employment.

(a) Profession;
(b) Vocation;
(c) Trade and manufacture; and
(d) Adventure or concern in the nature of trade.
Profession

- The word profession is not defined by the Act but normally involves the use of intellectual skill or other skills by a person. Simple examples of professions would be the like of singers, entertainers, doctors, painters and many more.
Vocation

- Vocation means the way in which a person passes his life. A person who makes a living even through systematic betting is following a vocation. Thus, any profit derived from the vocation such as betting is assessable under Section 4(a) business income.
Trade

- Trade involves something in the nature of a **commercial undertaking** where by buying and selling are the most evident characteristics. A trade must have the following features:

(i) It involves trading activities where buying and selling goods occurred.

(ii) Consists of a series of transactions, continuously happen, repetitive buying and selling activities or manufacturing and selling.

(iii) The intention of transaction is for making profits.
Adventure or Concern in the Nature of Trade

- The Act does not define the meaning of “adventure or concern in the nature of trade”. Thus, it always has a broad interpretation.

- These phrases are used in the Act, a determination is made based on the degree of activity and each situation must be considered in the light of its own particular facts.
The Existence of Business / Trade

- Badges of trade: a collection of principles established by case law to determine whether or not a person is trading.

- “Badges of trade” are vital as indicator to the existence of business.
The Existence of Business / Trade

- Subject Matter of the Transaction
- Intention of the Business Transaction
- The Frequency of the Transaction
- Length of Ownership
- Nature of Entity
- Alteration to Property
Subject Matter of the Transection

- The subject matter of the transaction must be analysed to determine whether the incomes received are revenue in nature or merely a capital gain.

- A capital gain will not be taxable under the Income Tax Act 1967. If the subject matter is treated as a trading stock, then the sale of it would be subjected to income tax.
Intention of the Business Transaction

- Business is said to exist when there is an intention to make profits from its transaction.
- When the subject matter (assets) are acquired for the purpose of profit-making, the profit from realisation of the subject matter will be treated as income in nature; thus it will be taxable.
Intention of the Business Transaction

- **Case law: Rutledge v CIR CS 1929 14 TC 490**

- On a business trip to Germany a taxpayer purchased one million toilet rolls. On returning to the UK the sole consignment of toilet rolls were sold to one individual for a profit. The profit made on this large quantity single purchase and resale item was ‘an adventure in the nature of trade’. The case was decided on the fact that the purchase was not made for own use or investment purposes.
The Frequency of the Transection

- A business must have some repetition of series of actions. The repetitive transaction is an evidence of the existence of business activity or trade.
The Frequency of the Transection

- **Case Law: IRC v Fraser 1942 24 TC 498**
- In IRC v Fraser 1942 24 TC 498, an isolated transaction in the purchase and re-sale of whisky in bond was held to be an adventure in the nature of trade. The nature of the commodity and quantity purchased was such that it could not reasonably be considered to be for own consumption, and there was insufficient evidence to indicate an investment motive.
Length of Ownership

The length of time an asset is held is an important indicator of trade. The longer the period of ownership the greater the chance of it been seen as an investment rather than a trade.
Length of Ownership


- A taxpayer purchased two large quantities of silver bullion to counter the effects of the devaluation of the pound. The purchase was made following advice and was partly financed by loan. As the purchase was done on a short term basis in order to realise profit. There was an adventure in the nature of trade and was therefore assessed as trading profit.
Nature of Entity

- It is easier to *infer* (conclude) the motive of partnership or a company is for *profit making*, but to an individual it is harder to recognise. However, if the *individual* registered his/her business, this would likely be an *inference of a profit making motive*. 
Alteration of Property

- It is important to take note of any changes or modifications made to an asset that may make it more marketable, such alteration would constitutes as a badge of trade.
Alteration of Property

- **Case Law:** Cape Brandy Syndicate v CIR – CA 1921, 12 TC 358; [1921] 2 KB 403.

- Members of a wine syndicate joined in a separate syndicate to purchase brandy from South Africa. Some was shipped to the East with the remainder being sent to London to be blended with French brandy, re-casked and sold at a profit. The taxpayer tried to argue that the transaction was of a capital nature from the sale of an investment. It was held that a trade or business was carried on and was assessable as a trading profit.
Derivation of Business Income

- Section 12(1) of the Income Tax Act 1967 states that gross income of any person shall be deemed derived from Malaysia when the business is carried on in Malaysia.
Derivation of Business Income

- Income from operation of business carried outside Malaysia would not be tax in Malaysia, because it is not derived from Malaysia (foreign income) although the income is remitted into Malaysia. However, this is not applicable to company under specialised industry (i.e. banking, insurance, air and sea transportation business).
Derivation of Business Income

- In order for a business to be tax in Malaysia, we must establish the evidence whether the following exists:

  - The existence of a business source;
  - The business profit is income in nature and not a capital gain; and
  - The business income is derived from Malaysia.
Derivation of Business Income

- In order to determine whether the business operation is carried on in Malaysia, at least one of the following conditions must be fulfilled:

(a) Contract concluded in Malaysia;
(b) Stocks are maintained in Malaysia;
(c) Passing of ownership and risk of trading stocks in Malaysia;
(d) Sale proceeds received in Malaysia; or
(e) Services rendered in Malaysia.
Basis Period for Business

- The basis period for an individual taxpayer is a calendar year i.e. from 1 January to 31 December of each year.

- Company, unit trust and club can choose to have their basis year either calendar year or the financial year end of a business.
Basis Period for Business

- There are two important things that you should know:
  - Commencement of Business
  - Single or Separate Business
Commencement of Business

It is important for you to determine the date when a business starts. This is due to the following reasons:

(i) Pre-commencement expense is not deductible (permanent loss);
(ii) Capital allowance is only given once the business commences its activity; and
(iii) Selection of basis period (year end of business or calendar year).
Single or Separate Business

- It is important to determine whether you are running one business or two businesses at the same time. This is important for the utilisation of the capital allowance. The capital allowance from one business cannot be set-off against the income from other business.
Gross Income of Business

- Gross income from a business must be in terms of revenue receipts. For Eg: income received from insurance claim will assessed as business income.
Gross Income of Business

- The following should also be treated as gross income from business:

(a) All debts arising in the course of carrying on the business [Section 24(1)].
(b) Market value of any stock in trade withdrawn for personal use of the proprietor [Sec. 24(2) & (3)].
(c) Dividend income from a share dealing company [Sec. 24(4)].
(d) Interest income of banks, financial institutions and money lenders [Sec. 24(5)].
(e) Bad debt written off in previous year was subsequently recovered. [Sec. 30(1)].
Adjusted & Statutory Income of Business

- The following should also be treated as gross income from business:
- An adjusted income of a business is derived by deducting the allowable expenses from gross business income.
Adjusted & Statutory Income of Business

- Statutory income of a business is arrived by deducting capital allowance, unabsorbed capital allowance and balancing allowance from adjusted business income adding the balancing charge (if any) to the adjusted business income.
Business Expenses

- **Section 33** of the Income Tax Act (ITA) 1967 provides the general types of expenses which qualify for deduction and **Section 34** of ITA 1967 gives specific types of business expenses which qualify for deduction, whereas **Section 39** of ITA 1967 lists down types of expenses which are prohibited for deduction.
Revenue expenditure is allowed to be deducted from gross income of a business. On the other hand, capital expenditure is not allowed to be deducted. It is prohibited under Section 39 of the Act.
Capital Expenditure & Revenue Expenditure

- There is no definition of capital or revenue expenditure in the Act. However, certain principles or tests can be carried out to distinguish between capital expenditure and revenue expenditure.
(a) **The Once-and-for-All Test**
Generally, if the payment is going to be spent once and for all, like a lump sum payment, it is regarded as capital expenditure. Revenue expenditure is a thing that is going to recur every year or repetitively. However, not all lump sum payment is regarded as capital expenditure such as payment of gratuity to retired employee.

(b) **The Enduring Benefit Asset Test**
Any expense incurred in bringing assets into existence for the long term is usually classified as capital expenditure.

(c) **Fixed Capital and Circulating Capital**
Any expense which relates to the fixed capital or fixed assets is generally be treated as capital expenditure while expenses relating to circulating capital is treated as revenue expenditure.
(d) **Business Structure versus Process**
When expenses incurred relates to business structure it is considered as capital expenditure. However when the expenses incurred relates to the business process it is regarded as revenue expenditure.

(e) **Initial Expenditure**
Initial expenditure usually refers to the expenditure incurred before the commencement of a business. Thus, these expenses are capital in nature.
Deduction Of ITA Act 1967

- General Deduction Under Section 33 of ITA 1967.
- Disallowed Expenses or Prohibited Expenses Under Section 39(1) of ITA 1967.
- Specific Business Deduction Under Section 34 of the ITA 1967
- Specific Deduction - Gazette Order.
General Deduction Under Section 33 of ITA Act 1967

- The expenses are allowed to be deducted we must ensure that the following conditions have been fulfilled:

  (i) Each business source has to be accounted separately because expenses that specifically relates to the business is allowable;
General Deduction Under Section 33 of ITA Act 1967

- (ii) The scope of expense refers to "outgoing and revenue expenses";

- (iii) The expenses have to be "wholly and exclusively" incurred in the production of gross income from that business source; and
General Deduction Under Section 33 of ITA Act 1967

• (iv) The *expenses have incurred* (paid, payable or becoming payable).

• Some examples of expenses which are allowed to be deducted from gross business income:

• (i) *Interest expense on borrowed money*;
General Deduction Under Section 33 of ITA Act 1967

- (ii) **Rental expenses for occupying** and using the properties and incurred for the purposes of producing gross income; and
(iii) **Repair and renewals.** However, repair expenses incurred on acquisition (purchase) is not allowed to be deducted because it is usually for the purpose to endure benefit of the assets. Expenses incurred to replace the old assets with new ones is also not deductible.
Disallowed Expenses or Prohibited Expenses Under Section 39(1) of ITA 1967:

(i) **Domestic or Private Expenses**
Domestic or private expenses are expenses which relate to owner’s or trader’s private residence such as owner wages and salary, contribution to owner’s EPF, private telephone bill and others.

(ii) **Expenditure Not Wholly Incurred in the Production**
Such expenditure includes charitable subscription, donation to political parties and wages and salary paid to family members. However, there are types of donation which are allowed to be deducted from total aggregate income of taxpayer [income from Section 4(a) to 4(f)].
Donations that are allowable for deduction are as follow:

- Cash donation to approved institution and government. However, cash donation to approved institution is limited to 7% (individual taxpayers) and 10% (corporations) of the aggregate business income.
- Cash donation to approved libraries limited to RM20,000.
- Cash or goods donation to public facilities.
- Cash or in kind of medical equipment for health care facility.
- An amount equal to the value of painting donated to the National Art Gallery.
- An amount equal to the value of artefact, manuscript or painting donated to government.
Disallowed Expenses Under Section 39(1) of ITA Act 1967

(iii) Capital withdrawn or any sum employed as capital.

(iv) Payment to any pension, provident saving or to any fund which is not an approved scheme.

(v) Qualifying mining, agriculture, forest, prospecting and farm expenditure.

(vi) Expenses to non-resident, where withholdings tax were not deducted by the payer.

(vii) Sum payable for the use of a license or permit to extract timber from forest.

(viii) Restriction to bonus payment. This paragraph was deleted with effect from year assessment 2002.

(ix) Failure to remit deduction from Contract Payment under Sec. 107A of the Act.

(x) Failure to remit deduction from Special Classes of Income under Sec. 109A of the Act.
Disallowed Expenses Under Section 39(1) of ITA Act 1967

(xi) Lease rental in respect of passenger vehicles used in business.

(xii) Leave passage provided to employee within or outside Malaysia is not deductible. However, leave passage within Malaysia from 1/6/2003 and 31/5/2004 shall be given double deduction.

(xiii) Entertainment expenses provided for employee. Entertainment is defined under Sec. 18 to include:

- The provision of food, drink, recreation or hospitality; and
- The provision of accommodation or travel in connection with or for the purpose of facilitating entertainment of the kind mentioned above.

However, a public ruling (3/2004) was issued on 8 November 2004 in respect of entertainment expenses. With effect from year assessment 2004, 50% from entertainment expenses incurred on clients by company or employee is allowed to be deducted.
Disallowed Expenses Under Section 39(1) of ITA Act 1967

Some exceptions as provided in Sec. 39(1)(l) where entertainment expenses which are related wholly to sales in the production of gross income will be given full deduction. The list of expenditures is as follows:

- Entertainment incurred on employee only, such as annual dinner and other event which involve only the employees. If the event involved others other than employee only 50% is allowed to be deducted.

- Expenses incurred by business which involve entertaining activities such as hotel and restaurant business.

- Expenses related to promotional gift at foreign trade fairs.

- Expenses related to promotional sample.

- Expenses related to entertainment for cultural event to promote business.

- Entertainment related “wholly to sales”. “Wholly to sales” means entertainment directly related to sales provided to customer, dealers, distributor except supplier. Examples of these entertainment expenses include:
Disallowed Expenses Under Section 39(1) of ITA Act 1967

- Food and drinks for the launching of a new product;
- Redemption vouchers given for purchases made;
- Discount vouchers, shopping vouchers, concert or movie tickets, meal or gift vouchers and cash vouchers; and
- Free gifts for purchases exceeding a certain amount.
Specific Business Deduction Under Section 34 of ITA Act 1967

(i) Bad debt and doubtful debts from trading activities. The Act only allows two types of debt to be deducted: bad debt written off and specific provision for bad debt. General provision is non-allowable.

(ii) Employer contribution to approved schemes is deductible.

(iii) Legal and professional expenses incurred by business are allowable expenses. However, these expenses must not result from business fault and not because of violation of law. If the expenses incurred is due to violation of law such expenses are not deductible.

(iv) Loss from advances to employees is allowable expenses.
Specific Business Deduction Under Section 34 of ITA Act 1967

(v) Expenses incurred on “Key-man” insurance

- Key-man is an important person in the business. Some businesses will buy a life insurance policy on the key-man. The premium paid for this insurance is allowable to be deducted from gross income if the policy has no element of investment and the beneficiaries go to the employer/company and it is not insured on director of a controlled company, partners in partnership or sole proprietor. Proceeds received on such policies will be assessed as part of business income.
(vi) Expenditure incurred by employer on the provision of equipment for disable employees for the performance of their duties will be given full deduction.

(vii) Expenditure in respect of translation/publication of cultural, literary, professional, scientific or technical books in Bahasa Malaysia which has been approved by Dewan Bahasa dan Pustaka.

(viii) Contribution to public libraries with maximum amount to RM100,000 for each year of assessment.

(ix) Expenses incurred on the provision of child care center for the benefits of employee.

(x) Social responsibility payment.
Specific Business Deduction Under Section 34 of ITA Act 1967

(xi) Expenses incurred on musical and cultural group approved by the minister.

(xii) Expenditure incurred on the provision of practical training to resident individual who is not the employee of the business.
Specific Deduction – Gazette Order

(i) Expenditure relates to information technology, starting from the year of assessment 2000 to current year assessment.

(ii) Cost incurred on developing website of a businesses starting from year of assessment 2002. The deduction is spread over five years of assessment.
(iii) Expenses incurred on the employment of unemployed graduates will be given double deduction. This incentive was made available in year of assessment 2004 to 2005. The graduates must be registered with the Economic Planning Unit and employed on or after 13/9/2003.
Specific Deduction – Gazette Order

• (iv) **Retrenchment** (cutting down cost) payment is not deductible.

• (v) **Expenses** incurred for Annual General Meeting (AGM) are not deductible.

• (vi) **Compensation to employee for dismissal of employment** is deductible.
Cessation of Business

A business can stop its operation temporarily or permanently. When business is temporarily ceased expenditures will be treated as the following:

- Revenue expenses are deductible in arriving at adjusted income.
- Any current year loss can be off set against aggregate income.
- Excess of the current year loss can be brought forward to future year to be off set against any business income.
- Capital allowance would continue to be claimed.
- Unabsorbed capital allowance can be carried forward to be off set against the particular business source of income.
Q & A