Director-General of Inland Revenue v. *L.C.W.*[1]

STOCK VALUATION:

Stock valuation for income tax purposes has always raised complex points of law. *Director-General of Inland Revenue* v. *L.S.W.* raises the question whether a transfer of a fixed asset of a business to the trading account should be made at the original cost of the asset when purchased or the market value of the asset at the time of transfer to the trading account.

The facts in brief are as follows. L.C.W., a businessman dealing in timber and rubber, bought a piece of land for $20,000 in 1953. This piece of land was subsequently surrendered to the Government by a Deed dated 21st May, 1958 in exchange for another piece of land. The taxpayer's intention was to construct flats on the land for the purpose of renting them out as an investment. He had no intention of developing the land for sale or to construct flats thereon for sale. In 1963 plans for construction of the flats were approved by the Town Board and by 1966 the building of the flats were approved by the Town Board and by 1966 the building of the flats were completed. Out of a total of 24 flats built 19 were sold as at 30th June, 1967. The financial year of the taxpayer ended on 30th June. The land which was always recorded as a fixed asset of the sole proprietorship was transfered from the fixed asset account to the trading account wherein the value thereof was entered at the market value in 1963, that is, $480,000.00.

Two points of law arose from the above set of facts, namely, (i) whether the taxpayer was carrying on a trade or an adventure or concern in the nature of a trade, and if so (ii) whether for purposes of computing the trading profits the value of the land should be taken as $20,000 (the actual purchase price in 1953) or $480,000/= the market price in 1963.

No comment is made in this note on point (i) that is, the finding of the Federal Court that the profits from sale of the flats are assessable under Section 4(a) of the Income Tax Act, 1967 as being profits from a business for the reason that this is not the first case in Malaysia on the subject of what constitutes trading and there is sufficient authority to support the decision.

Point (ii) cited above calls for comment for the reason that it is the first time that Section 35 of the Income Tax Act, 1967 has been judicially considered. Further, there is a lack of case law authority on the point raised.

Lee Hun Hoe, C.J. Borneo, who delivered the only detailed judgement based his conclusion that the market value is the proper value to be taken on the ground that the phrase "its cost price to the relevant person" in the

[1] [1975] 1 M.L.J. 250.

proviso to S.35(3)(a)(i) refers to the cost to the business of that person, that is, the market value at the time of appropriation in 1963. He said,

"The proviso to section 35(3)(a)(i) refers to 'its cost price to the relevant person'. Account must be taken of section 35(1). 'Relevant person' seems to indicate a person in relation to his business. The cost price referred to by the proviso would mean the cost to the business of that person, that is to say, the value of the land at the time of appropriation in 1963. The true value to the business is the market value in 1963 and not the original value in 1953. The proviso is a codification of accepted accounting principle in business or commerce."[2]

It is submitted that section 35(1) and the proviso to S.35(3)(a)(i) really do not cover the point at issue, that is, when a fixed asset is transferred to the trading account what is the value to be placed in the trading account. See. 35(1) reads as follows:—

"(1) Notwithstanding any other provision of this Part, in ascertaining the adjusted income of a person from a business for the basis period for a year of assessment, the value of the stock in trade of the business at the beginning and at the end of that period shall be taken into account in accordance with the following subsections (that person, business, period and stock in trade being referred to in those subsections as the relevant person, the business, the relevant period and the stock respectively)."

The proviso to Section 35(3)(a)(i) reads as follows:—

"Provided that in the case of any item of the stock consisting of inmovable properties, stocks, stocks, shares or marketable securities, the value thereof at the end of the relevant period shall be taken to be an amount equal to its cost price to that relevant person or its market value at that time which ever is the lower;"

It will be noticed from the provisions quoted above that in case of S.35(1) the provision is not only a general one but nowhere does it cover a case of the proper value to be placed on a fixed asset introduced as stock in trade. All that section 35(1) authorises is that stock in trade at the beginning and at the end of a business shall be taken into account in computing that adjusted income in accordance with the sub-sections of section 35. The learned judge said "Account must be taken of Section 35(1)" but unfortunately he did not elaborate in detail as to how account should be taken of Section 35(1) in solving the problem before the Court. Again, it must be noted that Section 35(1) covers only valuation at the *beginning* and *end* of accounting periods. The significance is that it does not give guidance as to the proper valuation to be placed of an item introduced say in between the beginning and the end of the accounting period.

[2] [1975] 1 M.L.J. 250 at page 255.

The learned Judge quite correctly pointed out that the first year of assessment under the I.T.A. 1967 is Year of Assessment 1968 and consequently there is no basis period for Year of Assessment 1967 under the Act. The learned Judge, therefore, referred to paragraph 17 Sch. 9 transitional and saving provisions for authority to determine the value of stock at the beginning of the basis period for Y.A. 1968. But this observation, correct as it is, does not give authority to determine the value to be placed on fixed asset introduced as stock in trade.

The learned Judge's comment that the "cost price referred" to by the proviso" [proviso to Section 35(3)(a)(i)] means the cost to the business, that is, the market value at the time of appropriation cannot be sustained as a statement of law for the following reasons:

(i) The proviso to S.35(3)(a)(i) contemplates the valuation at the *end* of the relevant period and the valuation to be taken at the end of the relevant period is either "its cost price to that relevant person or its market value at *that time*, which ever is the lower".

(ii) Following from (i) it is illogical to interpret "its cost price" to mean the market value especially when the proviso goes on to say that the cost price or market value which ever is lower is to be taken. If "its cost price" means "market value" then it will be apparent that it leads to an absurdity.

(iii) Further to (i) and (ii) above it is submitted that the proviso to section 35(3)(a)(i) is no authority to support the learned Judge's conclusion since the proviso covers only the valuation to be taken at the *end* of the relevant period. A fixed asset may be transferred to the trading account in the middle of a relevant trading period. By what amount should the trading account be debited with? Is it the actual cost price of $20,000? Or is it the market value at the time of transfer? These are points not covered by any statutory provision in the Income Tax Act, 1967.

Since the judgement cannot be supported by statutory provisions in the Income Tax Act, 1967, it now remains to examine whether the judgement can be supported by the other ground on which the learned judge based his conclusion namely, that there is a dichotomy between a owner of a business and the business itself. The distinction was drawn when the learned Judge said:[3]

> "When respondent converted his capital assets into stock-in-trade and started dealing in them the taxable profit on the sales must be determined by deducting from the sale proceeds the market value of the assets at the date of conversion into stock-in-trade since that is

[3] Ibid, at page 255

the cost to his business and not the original cost to him. See *C.I.T.* v. *Shiribai Kooka*[4]"

It is necessary to review *I.T. Commr.* v. *Bai Shiribai Kooka* (Supra) together with some background against which that case was decided. In *Shiribai Kooka* (supra) a Parsi lady held by way of investment a large number of shares which were purchased some time in 1939–40. The cost price at date of purchase was much less than the market value on April, 1. 1945, when the shares were brought into stock-in-trade. For the assessment year 1946–7 the question arose whether the debit to the trading account should be the cost price of the shares when purchased or the market-value at time of conversion of th shares into stock-in-trade. The question was answered by S.K. Das, J on the lines that the market value should be the cost debited to measure the profit arising from the transaction. S.K. Das, J said:

> "So far as the business or trading activity was concerned, the market value of the shares as on April, 1945 was what it cost the Business."[5]

It will be noted that S.K. Das, J. is drawing a distinction between a business and its owner. Such a distinction, it is submitted, cannot be supported in law since a sole proprietorship is not a separate legal entity. In fact the distinction is important only for purposes of double-book keeping (principles) entries, and if the account books are kept on single entries as is the case of small business in Malaysia the distinction loses its importance even for book keeping purposes. Sarkar, J saw the flaw in such a distinction when he delivered his dissenting judgement in *Shirinbai Kooka* (supra). He said:

> "... in *Kikabbai*[6] case it was expressly said that when the business owned by the assessee himself it is unreal to separate the business from its owner and treat them as if they were different entities trading with each other[7]"

Apart from the reason above there is another reason why the authority of *Shiribai Kooka* (supra) is doubtful. The decision in *Shiribai Kooka* is based on a distinction between the case and *Kikabbai* (supra). In *Kikabbai* (Supra) the taxpayer a dealer in shares and silver withdrew some silver and shares from his business to settle the same upon certain trusts. In the accounts he entered the silver and shares withdrawn at their cost price. The Revenue was of the view that the value of the silver and shares

[4](1963) A.I.R. S.C. 477; (1962) 46 I.T.R. 86 (S.C.)

[5]See [1975] 1 M.L.J. at page 255.

[6](1954) A.L.R. S.C. 509.

[7]Ibid, at page 485.

withdrawn should be entered at the market value. It was held by the court that the value should be the cost of the silver and shares.

S.K. Das, J ruled that the principle could not be applied in *Shiribhai Kooka* since

> "in one case there is no question of any business sale or actual profits and in the other admittedly there are profits liable to tax, but the question is how the profits should be computed."[8]

It is submitted that such a distinction has been given undue importance and ignores the fact that *Shiribhai* is the reverse problem of *Kikabhai* – not that a reverse problem should have a corresponding reverse ruling but that if in one case (*Kikabhai*) the ratio is that there is no authority under the Indian Income Tax Act "to tax a potential future advantage" then the Court should equally show the statutory authority to take the market value at the time of transfer as the correct method of computing profit for income tax purposes, especially where the actual cost to the taxpayer is known. In the absence of any statutory authority to support the decision in *Shiribhai* (supra), its authority is eroded by a recognition of the fact that there is in law no distinction between a business and its owner. *Shiribhai* (supra) can be contrasted with the decision in *Jacqilden (Weston Hall) Ltd.* v. *Castle*[9]. This has relevance to the problem at issue, although the learned Judge in *Director-General of Inland Revenue* v. *L.C.W. (supra)* did not refer to this case. In *Weston Hall* (supra) a taxpayer formed an investment company in May 1959. In March 1959 the taxpayer purchased a hotel with a view to erecting flats on the site for £88,000. He paid a deposit of £8,000 of which £7,000 was agreed between the taxpayer and his investment company as attributable to the hotel. On 29th Sept, 1959 the taxpayer authorized the vendors to convey the hotel to the Company for £72,000. The Company having cleared the hotel, sold the site in February 1960 for $155,000.

The Company claimed that when the hotel site was acquired for £72,000 by the Company, the site had a market value of £150,000 and that not only should £72,000 be debited as cost but also a further £78,000 should also be debited as cost being the value of the contract or purchase given by the taxpayer to the company as a gift. Thus, the issue was whether in computing profits on the sale of the site, the cost price of £72,000 should be debited or a sum of £150,000 the market value at date of acquisition should be debited. Plowman, J. concluded that the correct sum to be debited was the cost price of £72,000. Plowman, J said:

> "It seems to me that they[10] were entitled to conclude, as a matter of business common sense and notwithstanding any element

[8] Vol. 50, (1963) A.I.R. (S.C.) at page 580.

[9] 45 T.C. 685.

[10] The Special Commissioners.

of gift there may have been that the transaction with which they were concerned was not a gift or sale by Mr. Rowe to the Company at an undervalue, but a purchase by the company of trading stock at a price which had been fairly negotiated between Mr. Rowe and the vendors. The *Sharkey v. Wernher*[11] line of authority has never so far as I am aware, been applied to a case where the price at which the property passed had been negotiated as a fair and proper price, and because it is an exceptional line of authority I think that the Court should be slow to extend it[12]".

Weston Hall Ltd. (supra), it is submitted, supports the contention advanced here that where the cost price is known, that is the proper figure to be taken. Where the property introduced into the business is a gift then the market value at time of the gift may be taken[13]

The principle in *Sharkey* v. *Wernher* (supra)[14] as explained by Plowman J, above cannot be extended to a case like *Director-General of Inland Revenue* v. *L.C.W.* (supra).

For the reasons considered in this note, it is submitted that the decision in *Director-General of Inland Revenue* v. L.C.W. (supra) relating to stock-in-trade cannot be sustained.

Arjunan Subramaniam

[11] 36 T.C. 275.

[12] ibid, at page 700.

[13] See *Ridge Securities v. I.R.C. 44 T.C. 373 at page 392.*

[14] See *Mason* v. *Innes* 44 T.C. 326 where the limits of *Sharkey* v. *Wernher* are further defined.

LEGISLATION NOTES

THE HUMAN TISSUES ACT, 1974 [ACT 130] A MUSLIM LAWYER'S POINT OF VIEW

There is a tradition of the Holy Prophet (Peace be upon him) which is recorded in the *Sahih Muslim*. On his arrival at Medina, the Prophet observed some of the people of Medina pollinating their palm trees. He made the remark "Perhaps it would be better if you did not do it". The people concerned took his remark as an order, and the result was not what he had expected. This being reported to him he said: "I am but a human being. Only when I order you something of your religious duties will you have to abide by it. But if I issue an instruction upon my personal opinion, then it is a mere guess and I am only a human being Rather you may better know your worldly affairs".

Another important tradition is that relating to the appointment of Mu'adh ibn Jabal as Governor and Judge in Yaman. On the eve of his departure to assume his office there, the Prophet asked him "According to what will you judge?" He replied "According to the Book of God". "And if you find nought therein?" "According to the Sunnah of the Prophet of God." "And if you find nought therein?" "Then I will exert myself to form my own judgment". And thereupon the Prophet said "Praise be to God who has guided the Messenger of His Prophet to that which pleases his Prophet".

It is a principle of the Islamic law that in the absence of a clear ruling from the Holy Quran or the Sunnah of the Prophet, the jurist should use his best endeavours to find a solution using his judgment in the light of the teachings of the Holy Quran and the Sunnah. What is not clearly forbidden in the Holy Quran or the Sunnah is permissible and it is left to the Muslims to decide what action should be taken or what ruling should be adopted on the principle of "establishing what is good or right and avoiding what is evil or wrong".

There are many verses of the Holy Quran which show in the words of Dr. Said Ramadan that "Islamic law was not meant to paralyse people so that they might not move unless allowed to. Man on the contrary, is repeatedly called upon by the Holy Quran to consider the whole universe as a Divine grace meant for him and to exhaust all his means of wisdom and energy to get the best out of it."

"And He has made of service to you whatever is in the Heavens and whatsoever is in the earth; it is all from Him. So herein are signs for people who reflect" (XLV:13)

"Say (O Muhammad): Who has forbidden the beautiful gifts of God, which he has produced for his servants and the good things of his providing" (VII:32).