THE GENERAL DEDUCTIBILITY RULE FOR BUSINESS EXPENSE: A MALAYSIAN AND AMERICAN COMPARISON

Once a taxpayer has ascertained the amount of his gross income, disputes frequently arise as to whether an expenditure incurred is an allowable item in computing the adjusted gross income. In Malaysia, the United States, Australia and the United Kingdom, the general scheme is that in ascertaining adjusted gross income, certain express deductions and certain express or implied prohibitions of deductions must be taken into account. Where the expenditure is not spelt out either in the prohibiting section or in the section which allows specific deductions, it need not necessarily fall outside the scheme of deductions. As will be seen, if the outlay is a proper charge against income and fulfils ordinary principles of commercial trading, it is deductible.

A. *The Statutory Framework*

In Malaysia, the general deduction formula is provided for in section 33(1) of the Income Tax Act, 1967[1] which reads as follow:

> ". . . the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person from that source for that period all outgoings and expenses *wholly* and *exclusively* incurred during that period by that person *in the production of gross income* from that source . . ."

Section 33(1) of the Malaysian Act, thus, provides the test for determining what kind of expenses will be deductible and what kind of expenses will not be deductible.

The Malaysian provision has its counterpart in the following United States, Australian and United Kingdom tax provision. Section 162(a) of the United States Internal Revenue Code[2] provides that

> "There shall be allowed as a deduction all the *ordinary* and *necessary* expenses paid or incurred during the taxable year *in carrying on any trade or business* . . ."

In the Australian Income Tax Assessment Act 1936,[3] section 51(1) reads as follows:

[1](Act 53 — Revised 1971). Hereinafter referred to as "the Malaysian Act".

[2]Hereinafter referred to as "the I.R.C.".

[3]Hereinafter referred to as "the Australian Act".

> "All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are *necessarily* incurred in carrying on a business *for the purpose of gaining or producing such incomes,* shall be allowable deductions except to the extent to which they are losses or outgoings of capital or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income."

Section 130(a) of the United Kingdom Income and Corporation Taxes Act 1970[4] states that:

> "Subject to the provisions of the Tax Acts, in computing the amount of the profits or gains to be charged under Case I or Case II of Schedule D, no sum shall be deducted in respect of
>
> (a) any disbursements or expenses, not being money *wholly and exclusively* laid out or expended for the purposes of the trade, profession or vocation."

From the above quoted provisions, the following differences in statutory language may be noted:

(i) under sections 33(1) and 130(a) of the Malaysian and United Kingdom Acts respectively, the expense must be wholly and exclusively incurred in order to be deductible. In other words, the expense must be solely incurred in the production of income or for the purposes of the trade. On the other hand, sections 162(a) and 51(1) of the I.R.C. and the Australian Act respectively require that the expense be one which is necessary and ordinary before it can qualify for a deduction. Although the statutory language of "ordinary and necessary" appears to be more restrictive in scope than that of "wholly and exclusively", it will be seen[5] that the phrase "ordinary and necessary" has not been narrowly applied by the United States courts.

(ii) under sections 33(1) and 51(1) of the Malaysian and Australian Acts respectively, the expense must be incurred "in the production of income" as opposed to "incurred in carrying on any trade or business" in section 162(a) of the I.R.C. and "for the purposes of the trade" in section 130(a) of the United Kingdom Act. As the following discussion[6] will illustrate, the scope of the phrase "in the production of income" is not narrower than that of the phrase "in carrying on any trade or business" in section 162(a) of the I.R.C.

(iii) in regard to dual purpose expenses, namely, expenses with mixed business and personal character, in which the latter predominates, they are *generally* not deductible under the Malaysian, United States

[4]Hereinafter referred to as "the United Kingdom Act".

[5]*See, infra* pp. 149-151.

[6]See, *infra* pp. 146-148.

and United Kingdom provisions unless they can be divided into allowable and non-allowable parts. Under both the Malaysian and United Kingdom provisions, such expenses would not be regarded as *"wholly and exclusively"* incurred in the production of income. Under section 162(a) of the I.R.C. read together with the Regulations,[7] such expenses would not generally be regarded as "directly connected with or pertaining to the taxpayer's trade or business."[8] In other words, the expense is not primarily incurred for the purposes of the taxpayer's trade or business. The position in Australia is, however, different. Section 51(1) of the Australian Act provides for the apportionment of dual purpose expenses to the extent they are incurred in producing income.

B. *Some Questions Of Policy*

The question as to whether the tax system should do away with deductions, exemptions and exclusions and simply levy tax on gross income (that is, a tax on receipts), is clearly dependent on the meaning of "income". The most frequently cited definition of income is the so-called Haig-Simons definition, which is ". . . the algebraic sum of (i) the market value of rights exercised in consumption and (ii) the change in the value of the store of property rights between the beginning and end of the period in question."[9]

Another way of stating it is to say that any item which increases the net worth of the taxpayer plus the goods and services consumed by the taxpayer is income. Accordingly, personal expenditures are not allowable as they represent consumption and capital expenditures are deductible over the years and not taxed as there is no real increase in net worth during the years in question.

If the Haig-Simons approach is strictly followed, a vast array of exclusions, exemptions and special deductions in the I.R.C. and the Malaysian Act would be abolished. Not only would salaries, dividends and profits from a business be taxed, but all interest on State and local bonds, all net capital gains from the sale of securities and other property, all appreciation in the value of property transferred by gift or at death, damages received in personal injury cases and welfare payments would be included and taxed like ordinary income. Moreover, under such a strict no-preference concept, all special allowances now permitted such as percentage depletion in excess of cost for old and other mineral income would be disallowed and a host of non-cash benefits such as the imputed value of owner-occupied homes, the household services performed by a non-working wife would be taxable. All these exemptions, special deductions and exclusions now given by the I.R.C. and the Malaysian Act have been regarded by the

[7] Regs, 1.162-1(a), 1.162-2(a)-(b).

[8] *Ibid.*

[9] H. Simons, *Personal Income Taxation* (Chicago: University of Chicago Press, 1938) at pp. 61-62.

critics as undermining the fairness of the tax system since they all seem to constitute income[10]

Accordingly, the only deductions from income permitted would be business expenses and expenditures incurred in connection with the production of income. None of the usual personal deductions now permissible (such as charitable donations, medical expenses, casualty losses, State and local taxes) would be allowed.

However, the goal of imposing a tax on all income is virtually impossible to reach,[11] not the least of which is how to draw the line between business expense, which are allowable and personal expenditures, which are not. As a result, the supporters of such a system will allow exceptions to be made in cases where the problems of measurement or evaluation or other administrative difficulties make it too costly or otherwise impractical to include items which seem clearly to constitute income to the taxpayer. Professor Bittker of Yale insists that the exceptions would be so numerous that the so-called ideal income tax would be as complicated as the present tax law. But the tax scholars who have responded to his attack on the comprehensive tax base concept feel that Professor bittker exaggerates the problems, most of which, they feel, will lend themselves to a practical solution.[12]

However, it is submitted that the goal of creating a comprehensive tax base and imposing a tax on all income is virtually impossible to reach. For example, there is a vast array of federal, state and local government programmes such as road building and maintenance, government guarantees of loans to businesses or individuals, which benefit many taxpayers and therefore constitute income to them in an economic sense. There are also non-pecuniary benefits in some jobs, for example, the opportunity to be creative or to exercise power, which are not taxed, although they may confer great psychic income. Most of these are not likely subjects for imposition of tax because to do so is either impossible or unpalatable. In view of all these considerations, it seems impossible to create a truly fair income tax which reaches all income and which imposes the same tax on people with about the same income.

Apart from the Haig-Simons definition of income, the term "income" may be taken to mean the amount that a person spends, that is, an expenditure or spending tax.[13] The expenditure tax (or the consumption-type in-

[10]See Blum, "Federal Income Tax Reform — Twenty Questions", (1963) *Taxes* 672; Galvin, "Progress in Substantive Tax Reform", (1965) *U.S. Cal. Tax Inst.* 1; J. Pechman, *Federal Tax Policy* (4th Ed., Washington, D.C.; Brooking Institution, 1983).

[11]See Bittker, "A Comprehensive Tax Base As A Goal Of Income Tax Reform", (1967) 80 *Harv. L. Rev.* 925. Other problems, discussed by Bittker, with creating a comprehensive tax base include the treatment of various deductions, the installment method of accounting and the extent to which the tax system should take account of family relationships.

[12]Musgrave, "In Defense of An Income Concept", (1967) 81 *Harv. L. Rev.* 44; Pechman, "Comprehensive Income Taxation", (1967) 81 *Harv. L. Rev.* 63.

[13]The application of this concept to the American tax system has been developed in Andrews, "A Consumption-Type or Cash Flow Personal Income Tax", (1967) 87 *Harv. L. Rev.* 1113. See also N. Kaldor, *An Expenditure Tax* (London: George Allen & UnwinLtd., 1955).

come tax, as Professor Andrews calls it) is based on the consumption element. The expenditure base is the income reduced by current savings or increase by spending for consumption out of prior savings (or out of borrowing). Under an expenditure tax, one must account not only for income (computed by allowing most of the deductions permitted under the income tax) but also for certain changes in savings. One starts with income (such as wages, salaries, dividends and so on less the deductions permitted under the current income tax) and then allows a deduction for savings to arrive at the tax base. Since the savings have not borne a tax, when they are drawn down for consumption they are then added to the tax base.

The long-standing argument in favour of taxing consumption rather than income, namely, that a tax on income unfairly taxes savers twice - once on the money originally earned and again on the interest earned from saving and investing it - is often illustrated by comparing the ability to consume in the future of a person who saves in a no-tax world with the same person under a consumption tax regime and under an income tax regime. It is easy to demonstrate that an income tax reduces the amount that one can consume in the future because a tax must be paid on the income saved and interest earned and that therefore the taxpayer has a smaller amount to invest than a taxpayer in a no-tax world or under a consumption tax regime that does not tax amounts saved. Under a consumption tax, by contrast, the ratio between present and future consumption opportunities (and thus the incentive to save) remains the same as it would be in a no-tax world. However, the behaviour assumption of this argument is suspect because any tax that reduces the total amount a taxpayer has available for saving and spending will likely affect the proportion he decides to allocate to each use. Furthermore, it is convincing only if one accepts a no-tax world as a standard for judging the desirability of a tax.

Another objection that advocates of the expenditure tax make about the income tax is that income is not a satisfactory measure of ability to pay. While it is admitted that both wealth and unexercised earning capacity increase a person's ability to pay, neither of these sources of ability to pay should be part of a tax base. This is because wealth is often in a non-liquid form and furthermore, a tax on wealth may be unacceptable because it would be perceived as taking something to which people have a stronger claim than they have to money received in a year as income. Ignoring unexercised earning capacity is justifiable since measuring capacity on a large scale would be impossible and forcing people to choose work over leisure solely to pay tax would be an unacceptable restriction on freedom. Accordingly, income is left as the least objectionable measure of ability to pay.

Also an expenditure or consumption tax would not be easier to administer or be more convenient for taxpayers. The administrative burden on the tax department and the compliance costs borne by the average taxpayer would be much greater under an expenditure or consumption tax than an income tax: while all business costs would be deductible under an expenditure tax on a current basis, large non-recurring expenditures, such as housing, would likely have to be capitalized and depreciated under an expenditure tax; the borderline between consumption and investment would be

difficult to draw and the need to keep track of banking and other financial transactions would impose record-keeping burdens on the average taxpayer.

In the light of the foregoing criticisms of both the comprehensive tax base concept and the consumption tax, it is accordingly submitted that rather than drastically changing the present system, with all the formidable costs that would entail, we should accept the inevitable imperfections of the present system and improvise where we can as we learn from experience.

C. *Judicial Interpretation: The Requirements For A Deduction The Malaysian Position*

It is evident from section 33(1) of the Malaysian Act that an expenditure is deductible if it is expended wholly and exclusively for the purpose of producing income and is incurred in the period which forms the basis for the income that is to be assessed. Although this section has been judicially considered in a number of cases, its scope and effect have not been fully delineated by the courts as yet.

(i) *Wholly and Exclusively*

The rigidity of the words "wholly and exclusively" is often disturbing to taxpayers. What is wholly and exclusively laid out to produce income is a question of fact and the circumstances of each taxpayer would have to be considered on their own merits.

It is proposed to consider the judicial interpretation of the phrase "wholly and exclusively" in relation to the following expenses:

(a) *Travelling Expenses*

The phrase "whole and exclusively" was interpreted quite stringently in the case of *D and Others*.[14] The facts were that the appellants were concert artists from London on a Far East tour. Sponsored by their agents in Singapore, they gave performances at the National Theatre for which they were paid a lump sum. Upon the Comptroller of Income Tax disallowing any deduction for the costs of air travel that had been incurred by them for flying from London to Singapore on the ground that the expense was not incurred solely to give a performance in Singapore, the appellants appealed to the Board of Review.

The Chairman of the Board of Review in sustaining the decision of the Comptroller of Income Tax, held that the appellants did not incur the expenses "wholly and esclusively" in the production of income because the costs were not incurred merely to come to Singapore but to other countries in the region as well.

Speaking of the phrase "wholly and exclusively" in section 14 of the then Singapore Income Tax Ordinance (the words of which were similar to section 33(1) of the Malaysian Act), the Chairman said,

[14] [1969] 2 M.L.J. xvi.

> "The parties are agreed that it must be assumed for the purposes of this appeal that the appellants were on a Far East tour. They did not incur the costs of air travel merely to come to Singapore to give their performances. They were off elsewhere in the region for a similar purpose. In these circumstances, having regard to the observations that have been made by the courts in England to a phrase not dissimilar to that in section 14. . . to which I have referred, I find that the appellants had not wholly and exclusively incurred the costs of air travel for the purpose of the production of income. Therefore, the appellants are not entitled to any deduction in respect of their costs of air travel from London to Singapore."

Notwithstanding the above decision, in practice the Director-General of Inland Revenue allows a proportion of travelling expenses incurred by artists who perform in Malaysia as one of the several venues of their tour.

In another case, *Re S*,[15] a ship's pilot claimed deductions for the whole of the travelling expenses incurred by him under section 14 of the then Singapore Income Tax Ordinance. This involved travelling from his home to the ship or from his home to the office and thereon to the ship. The Revenue accepted the expenses from the office to the ship as admissible and rejected the balance. The taxpayer contended that as travelling was necessary at all times of the day and night and as he had a telephone at home at which he could be contacted by the pilot's office at any time, his residence should be regarded as an "office" for the purposes of the claim. Accordingly, the expenses from his houses to the ships should rank as having been "wholly and exclusively" incurred. However, as the taxpayer's contention above could not be supported on the facts, the Board accepted the Revenue treatment of the expenses and rejected the taxpayer's argument that his home ought to be treated as his office in such circumstances.

In contrast, in *Pook* v. *Owen*[16] a majority of the House of Lords found in favour of the taxpayer in this context. In that case, the taxpayer carried on practice as a general medical practitioner at his residence. He also held a part-time appointment as obstetrician and an aesthetist at a hospital fifteen miles away. On occasions he was on stand-by duty, and during those periods he had to be accessible by telephone. There was a finding of fact that his responsibility for a patient began as soon as he received a telephone call. On receipt of the call he gave instructions to the hospital staff, and usually he then set out immediately by car for the hospital; but sometimes he advised treatment by telephone and awaited a further report. Lord Guest said,

> "It is note worthy that under . . . his conditions of service . . . the hospital is referred to 'where his principal duties lie'. There were these two places where his duty is performed, the hospital and the telephone in his consulting room. If he was performing his duties at both places it is difficult to see why

[15] (1953) S.B.R. 691.

[16] (1969) 45 T.C. 571.

> on the journey to the two places, he was not equally performing his duties . . . It follows that he had to get from his consulting room to the hospital by car to treat the emergency. The travelling expenses were, in my view, incurred in the performance of the duties of his office."[17]

Re S can be distinguished from *Pook* v. *Owen* in that the pilot in *Re S* was not really on stand-by duty although this was not a decisive factor. Even if he was on stand-by duty, his duties did not begin until he reached his ship, while the duty of the doctor in *Pook* v. *Owen* began with the telephone call since he gave general instructions to nurses over the phone before he reached the hospital.

Thus, travelling expenses between home and workplace may be allowable if the taxpayer's home can be said to be his base of operations. In *Horton* v. *Young*,[17a] the Court of Appeal unanimously held that a self-employed bricklayer whose base of operations was his home was entitled to deduct the expenses of travelling between that base and the building sites where he worked. The taxpayer entered into contracts with a builder and main-contractor for bricklaying on various sites where the latter was building houses. These contracts were always negotiated in the taxpayer's home. In the lounge of his home, the taxpayer had an office table, a typewriter and a number of files for keeping business papers. On these facts, the Court of Appeal found that the taxpayer's only base of operations was his home and accordingly, the travelling expenses from his home to his place of work were deductible.

Closely tied up with the phrase "wholly and exclusively" is the question of apportionment. This is particularly so where an expenditure has a dual aspect, namely, expenditure that is partly attributable to the production of income and falling within section 33(1) and expenditure which is of a private nature. Although the words "wholly and exclusively" appear to reject the deductibility of expenditure which has a dual motive, the apportionment of such a type of expenditure is acceptable. Where a taxpayer can establish to the satisfaction of the Director-General of Inland Revenue that a portion of the expenditure is incurred wholly and exclusively for the taxpayer's trade or business, he is entitled to a deduction in respect of it. The issue of apportionment arose in the case of *Re A Taxpayer*.[18] In this case, the taxpayer took up employment as a music teacher. Her duties entailed travelling and for this purpose a second-hand car was purchased. The Revenue contended that the cost of insurance and road tax were not "wholly and exclusively" incurred in the production of income since the car was used for purposes besides that of the taxpayer's employment. The Court however, allowed the taxpayer a deduction for expenses made in the course of duty other than those between home and the place of employment on the following formula:

[17] *Ibid.* at p. 590.

[17a] (1971) 47 T.C. 60. See also Smith, "Travelling Expenses", (1977) *Brit. Tax Rev.* 290.

[18] (1956) 22 M.L.J. 216.

$$\text{Total Running Costs of Car} \times \frac{\text{Duty Mileage}}{\text{Total Mileage}}$$

In other words, a fraction of the total costs of running the car in respect of the duty mileage was wholly and exclusive incurred in the performance of her duties. It would appear that where an expenditure is for a dual purpose that expenditure strictly does not come within the requirement of "wholly and exclusively" incurred. But this does not mean that an expense partly incurred in the production of income is not allowable at all.

(b) *Entertainment Expenses*

In the area of business entertainment expenditure, a broader view has been taken in the interpretation of the phrase "wholly and exclusively".

In *Bentleys, Stokes & Lowless* v. *Beeson,*[19] the issue was whether expenditure incurred in entertaining clients was "wholly and exclusively" laid out for the purposes of the trade although it involved an element of hospitality. In that case, Romer L.J., in delivering the court's judgment, expounded the following principles:

> "The relevant words. . . "wholly and exclusively laid out or expended for the purposes of the trade" appear straight-forward enough. It is conceded that the first adverb — "wholly" — is in reference to the quantum of the money expended and has no relevance to the present case. The sole question is whether the expenditure in question was "exclusively" laid out for business purposes, that is: What was the motive or object in the mind of the two individuals responsible for the activities in question?
>
> It is. . .a question of fact. And it is quite clear that the purpose must be the sole purpose. If the activity be undertaken with the object of both promoting business and also with some other purpose, for example, with the object of indulging an independent wish of entertaining a friend or stranger or of supporting a charitable or benevolent object, then the paragraph is not satisfied though in the mind of the actor, the business motive may predominate. However, if the sole object is business promotion, the expenditure is not disqualified because the nature of the activity necessarily involves some other result, or the attainment or furtherance of some other objective, since the latter result or objective is necessarily inherent in the act."[20]

Accordingly, it was held in the case that expenditure incurred in entertaining clients was "wholly and exclusively" laid out for the purposes of the business although the expenditure involved an element of hospitality. The Court found that there was no deliberate and independent wish or motive that is independent of the business purposes to be served in entertaining the firm's clients.

[19](1952) 33 T.C. 491.

[20]*Ibid.* at pp. 503-504. See also Grout, "'Wholly and Exclusively' And Duality of Purpose" (1979) *Brit. Tax Rev.* 4.

However, where there is such a motive independent of the business purpose to be served, so that the expenditure is not wholly and exclusively incurred for business purposes, it will be totally disallowed unless it can be apportioned into allowable and non-allowable parts. In *Copeman* v. *Flood,*[21] it was held that such a division could be made where excessive remuneration had been paid to directors of a company. The directors in question were a son and daughter employed in a family company, who had each received fees of $2,600 for minimal duties as a telephonist and buyer, respectively. The Court only allowed a proportion of those fees genuinely expended wholly and exclusively for the purpose of the company's trade.

From the foreging cases, it is clear that the business motive in incurring the entertainment expense must predominate in order that the expense be deductible. However, in cases where the expense is incurred only incidental to the business purpose to be served, apportionment may still be possible so long as the taxpayer can substantiate the part of the expenditure which is incurred in relation to the business or trade.

(c) *Conference Expenses*

Often a taxpayer who attends a business meeting or convention is faced with the question of whether the expenses of the trip will be fully deductible. In *Bowden* v. *Russell & Russell,*[22] the question of duality of purpose was considered. The facts were that the sole partner of a firm of solicitors, whose practice was not of an international nature, visited America and Canada with his wife to attend, in an unofficial capacity, the annual meeting of the American Bar Association in Washington and the Empire Law Conference in Ottawa. He intended to have a holiday at the same time. On his claim that the cost of the visit was deductible for tax purposes, the court held that as the purpose of the visit was not exclusively to enable the taxpayer to attend the conferences but substantially included holidays and social purposes, the expenses incurred were not deductible.

It is surprising to note that the question of apportionment was not raised in the case. In the light of *Copeman* v. *Flood* it could be argued that a part of the expenditure was in fact wholly and exclusively incurred to enable the taxpayer to attend the conferences. In such a case, it would be for the taxpayer to substantiate his claim with documentary evidence as to each element of an expense to qualify for a deduction.

This case should be contrasted with *Edwards* v. *Warmsley,*[23] where a firm of chartered accountants, in response to the desire of their professional body, sent a partner as a representative to an International Congress of Accountants in New York. The partner sent would not have gone

[21](1940) 24 T.C. 53.

[22](1965) 42 T.C. 301.

[23](1967) 44 T.C. 431.

to America if he had not been instructed by his partners to do so; while he was there, he only met people he had been instructed to see. It was held that as the sole purpose of the partner in going to America was to attend the Congress, the expense incurred in attending the Congress was deductible.

(ii) *Incurred*

The word "incurred" does not only mean paid. An expenditure can be incurred without it being disbursed. Thus, where a trader keeps his accounts on an accrual basis, he takes into account all the liabilities to which he has become subjected to at the end of the taxable year and these are allowable as deductions notwithstanding the fact that the disbursements have not actually been effected. On the other hand, where the cash basis is employed and a provision is made for expenditure which will crystallize only in a period subsequent to the accounting period under review, the expenditure does not rank for deduction against the profits that are being assessed. Under the cash basis, deductions are only allowed for expenses which have been actually disbursed during the taxable year in question.

It must be shown that the person claiming the deduction suffered the expense. In other words, the expenditure must be incurred by the taxpayer concerned. In *H. Rubber Estate Berhad* v. *Director-General of Inland Revenue*,[24] it was held that redundancy payments paid to workers on sale of an estate was not deductible under section 33(1) of the Malaysian Act as they were not incurred by the taxpayer claiming the deduction. In this case the facts were that H. Rubber Estate had merged with R. Rubber Estate on 1st January 1974. Prior to the merging, H. Rubber Estate had in November, 1973, served notices to its workers to terminate their services. The workers received redundancy benefits upon their services being terminated. These payments were in accordance with the terms of an agreement reached in 1969 between the Malayan Agricultural Producers Association (of which H. Rubber Estate was a member) and the National Union of Plantation workers. Payments to the workers were made by R. Rubber Estate in January, 1974, in accordance with an agreement with H. Rubber Estate. The payments totalling $26,000 were charged in the profit and loss accounts of H. Rubber Estate for the year ending 31st December 1973. The Court observed that the taxpayer (H. Rubber Estate) did not suffer the expense but in fact it was R. Rubber Estate which paid the sum of money. H. Rubber Estate was, accordingly, held not entitled to deduct the payments made by R. Rubber Estate.

It is submitted that the Court's holding is justified. Just because there is a duty to pay, it does not follow that what was paid was paid by the person who had the duty to pay. Moreover, section 33(1) of the Malaysian Act is not based upon duty to pay but whether an expense was incurred by a person in relation to his business. If an expense was not in fact incurred by a taxpayer, he has no right to a deduction.

[24] [1979] 1 M.L.J. 115.

(iii) *In The Production Of Gross Income*

The deductibility of expenditure appears to be somewhat restricted by the use of the words "in the production of gross income" in section 33(1) of the Malaysian Act as compared to the phrase "for the purposes of the trade" in section 130(a) of the United Kingdom Act. This difference was noted in the following two cases in regard to section 86(1)(a) of the then New Zealand Land and Income Tax Act 1954 which stipulated that no deduction is to be made in respect of expenditure not exclusively incurred "in the production of the assessable income."

In the English case of *Morgan* v. *Tate & Lyle Ltd.*,[25] Lord Morton observed that the aforesaid New Zealand provision was narrower than section 130(a) of the United Kingdom Act. In *Morgan's* case, the facts were that a company carried on a business of sugar refiners. The directors of the company were concerned by the threat of nationalization of the sugar industry by the then Labour Government. Because of such threat, the directors of the company decided to launch an anti-nationalization propaganda campaign with the object of preventing nationalization and thereby preserving its business and assets.

Upon the above facts, Lord Morton found that the expenditure incurred in the anti-nationalization campaign was incurred for the purposes of the company's trade. He said,

> "Looking simply at the words of the Rule, I would ask: If money so spent is not spent for the purposes of the company's trade, what purpose is it spent for? If the assets are seized, the company can no longer carry on the trade which has been carried on by the use of those assets. Thus, the money is spent to preserve the very existence of the company's trade."[26]

In regard to the New Zealand provision, his Lordship said,

> "The language of the New Zealand statute is much narrower."[27]

The New Zealand provision was considered by the Privy Council in *Ward & Co Ltd.* v. *Commissioner of Taxes*.[28] In this case a brewery company carrying on business in New Zealand expended money in printing and distributing anti-prohibition literature. It was done in view of a poll to be held on the question whether or not prohibition of intoxicants should be introduced. The poll resulted in a small majority against prohibition.

Viscount Cave of the Privy Council held that the expenditure was not incurred in the production of assessable income. His Lordship said,

[25](1954) 35 T.C. 367.

[26]*Ibid.* at p. 410.

[27]*Ibid.* at p. 412.

[28][1923] A.C. 145.

"We find it impossible to hold that the expenditure was incurred exclusively, or at all, in the production of the assessable income. It was incurred not for the production of income, but for the purpose of preventing the extinction of the business from which the income was derived, which is quite a different thing."[29]

It is submitted that there is no difference between expenditure incurred for the purpose of carrying on a business from which the income is produced and expenditure incurred for the production of income. This is because it is only from the carrying on of a trade or business that the income in question is derived. In other words, expenses incurred to prevent the extinction of a business or its assets are also incurred to ensure the continued production of income. Accordingly, it is impossible to hold that expenditure incurred for the carrying on of a business from which the income is produced is any different from expenditure incurred for the production of income.

It is to be noted that the phrase "in the production of gross income" does not mean that before any expenditure can rank for deduction, it must be established that it has produced income in the year in which the expenditure is incurred. It is sufficient for a taxpayer to show that the outlay was for the purpose of earning income, whether in the year under review or in a future year. In other words, there must be a good connection between the expenditure incurred and the earning of the income of the trade and it does not matter that the only benefit to be derived from that payment is to accrue in the future. Thus, in *Vallambrosa Rubber Co. Ltd.* v. *Farmer,*[30] only one-seventh of the taxpayer's company's estate produced rubber in the year in question, the other six-sevenths being in the process of cultivation for future production. It was held that the whole of the expenditure for the superintendent and weeding of the estate and various other items of expenditure on keeping the estate in good condition, were deductible in computing the profits of the company for the year in question and that provided the taxpayer reasonably believed that the expenditure then incurred would produce a counter-vailing benefit in the future, the fact that that expected benefit does not, in the event, materialize is not sufficient to render that expenditure nondeductible.

It is accordingly submitted that the following categories of expenditure would qualify for deduction as being incurred wholly and exclusively in the production of income:

(i) expenditure incurred with the intention, at the time the outlay was made, of producing income. It is not relevant whether or not any income in fact was produced.
(ii) expenditure laid out in a year but which has not produced any income in that year.

[29] *Ibid.* at p. 149.

[30] (1910) 5 T.C. 529.

Under section 33(1) of the Malaysian Act, bad debts are deductible only if the debts are incurred in the production of income for the business. In other words, the debts are allowable if they arose in the course of business or an ancillary business. In *X* v. *Comptroller of Income tax,*[31] the court was presented with such an issue. The facts were that the taxpayer carried on the business of a building contractor. During the course of the business he borrowed and lent large sums of money without security. In this case, the taxpayer agreed to lend a sum of $100,000 to one Y without security. After the loan was made, Y was subsequently adjudicated a bankrupt. The taxpayer sought to deduct the loan from his business profit. He contended that there was a practice or custom amongst building contractors of borrowing and lending money not for profit but as an activity ancillary to their own business and, accordingly, the loan was a bad debt incurred in his business. The Court rejected the claim of the taxpayer holding that the loan made by the taxpayer was not incurred in the production of income for the business as there was no evidence of such a practice or custom amongst building contractors of borrowing and lending money.

In relation to legal expenses, there are no specific provisions in the Malaysian Act governing their deductibility. Generally, where a taxpayer has incurred legal expenses in litigation, the test for deductibility is whether the expenditure was directly related to and incurred with the object of producing income of the business. Thus in *Usher's Wiltshire Brewery Ltd.* v. *Bruce,*[32] legal expenses incurred by a brewery company in connection with the granting and termination of lease of its public houses, the renewal of licenses and various incidental matters were held to be deductible for income tax purposes.

However, legal expenses incurred in ascertaining the exact amount of profits chargeable to income tax are not deductible expenses for tax purposes. In *Smith's Potato Estates Ltd.* v. *Bolland,*[33] it was held that the legal costs incurred in connection with the ascertainment of liability to excess profits tax were not deductible for income tax purposes because the expense was incurred not to produce the income of the business but to discover what sum is to be paid to the Revenue authorities out of the profits or gains which have already been earned. Under section 33(1) of the Malaysian Act, such expenses would also be disallowed as the expenses are incurred only to dispute the amount of tax payable on the income that is already earned or produced.

The United States Position

Section 162(a) of the I.R.C. broadly authorizes a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year

[31](1958) 24 M.L.J. 55.

[32][1915] A.C. 433.

[33][1948] A.C. 508.

in carrying on any trade or business. . .". The section generally allows a business to subtract from its gross income the expenses of producing the income before the tax liability of the business is calculated. The expenses to be deducted must be (i) ordinary and necessary (ii) paid or incurred during the taxable year (iii) in carrying on (iv) a trade or business. Each of these requirements is discussed separately below.

(i) *Ordinary and Necessary*

Only "ordinary and necessary" expenses paid or incurred during the taxable year in carrying on any trade or business are deductible. The expenses must be *both* ordinary and necessary or they are not currently deductible.

In *Welch* v. *Helvering*,[34] this requirement was not met. In this case, an officer of a bankrupt corporation paid the business debts with personal funds to re-establish his relationship with its customers. The Supreme Court held that those payments were not deductible because although they might have been necessary in establishing the taxpayer's credit, they were not ordinary in the sense of being expenditures that most taxpayers in the same situation would have made. As to the meaning of the word "ordinary", the Supreme Court in the aforesaid case was of the opinion that an expense would be considered such if it is customary or usual within the practice of a particular business community. In other words, an expense will be considered ordinary if it normally occurs in connection with businesses similar to the one operated by the taxpayer claiming the deduction.

However, the opinion of the Supreme Court on this point can be criticized on the ground that since section 162(a) of the I.R.C. aims at reducing the gross income derived from business by related expenses, then if the expenditure in question was dictated by the taxpayer's business judgement, it ought to be deductible even if found to be not customary within the practice of the particular business community. The case of *Friedman* v. *Delaney*,[35] in which a voluntary debt repayment by the taxpayer was disallowed, can be distinguished on the ground that the repayment there in question was personal and not dictated by business reasons of the taxpayer and hence not ordinary and necessary.

A further criticism can be made of the Supreme Court's opinion in *Welch's* case that the expenditure was not ordinary but belonged to the category of capital expenditure because the debt repayments were made by the taxpayer to re-establish goodwill relationship (a capital asset) with the customers of the old business enterprise. The Supreme Court failed to notice that the taxpayer was merely trying to maintain goodwill relationship among customers or clients which he already knew. Accordingly, the debt repayments were incurred for the purpose of protecting something he already possessed and not for the creation of a new resource. Thus, the expenditure incurred should have been held to be deductible currently and not a capital expenditure.

[34](1933) 290 U.S. 111.

[35](1948) 171 F. 2d 269 (1st Cir.).

The use of the term "ordinary" and "necessary" as a device to distinguish capital expenditure from current expense and personal from business expense, may also be seen in the case of *Commissioner* v. *Tellier*.[36] In this case, the Supreme Court was of the view that the legal expenses incurred by the taxpayer in his defence against charges of past criminal conduct were both ordinary and necessary in carrying on his business. They were ordinary because they did not result in the acquisition of a new capital asset. Rather they were incurred to defend against charges of fraud in the sale of securities in respect of which the taxpayer carried on an existing trade or business. They were also necessary (and hence not personal) in the sense of being helpful and appropriate for the development of the taxpayer's business. Accordingly they were business expenses deductible currently.

The view that expenses to be "ordinary" do not have to habitual, finds support in the case of *Deputy* v. *Du Pont*,[37] where the Supreme Court took the view that ordinary expenses were not those that are habitual in the sense that the same taxpayer will have to make them often. In fact, the expense may occur only once in the lifetime of a business. So long as the expense is usual or customary in the type of business in which the expense was incurred, it is deductible. Thus, it is submitted that it is for the courts to examine the type of business involved and the business customs to determine whether an expense is "ordinary". Accordingly, whether an expense is "ordinary" must turn on the special facts of each case, which are affected by the time, place and circumstances of the expense.[38]

As to the meaning of the word "necessary", it has been construed in *Welch* v. *Helvering* as imposing the requirements that the expense be "appropriate and helpful" for the development of the taxpayer's business. In *Welch's* case, the Court found that the payments made by the taxpayer to creditors of the bankrupt corporation were appropriate and helpful for the development of his own grain commission business. The Supreme Court also pointed out that any payment which the taxpayer reasonably believes is appropriate and helpful to the business will normally qualify as necessary. Accordingly, the taxpayer's judgment as to what is a necessary expense is generally accepted by the courts.

However, where as in *Friedman* v. *Delaney* the expense is a voluntary underwriting of the obligation of another, so that it is motivated by personal rather than business reasons and hence not necessary, the expense will not be allowed under section 162(a) of the I.R.C.

The fact that an expense may, in hindsight, turn out to be unwise, in that it did not help the development of the business, is irrelevant if the taxpayer believed it to be appropriate and helpful at the time it is incur-

[36](1966) 383 U.S. 687.

[37](1940) 308 U.S. 488.

[38]*Ibid.*, at pp. 495-6.

red. Thus in *Fumigators, Inc.* v. *Commissioner,*[39] the taxpayer paid an unrelated corporation a sum of money pursuant to a contract under which the said corporation was to provide management and consulting services to the taxpayer in the fumigating business. The corporation performed few services for the taxpayer and the taxpayer received little benefit for its payment. The Tax Court held that as the taxpayer had a reasonable expectation of receiving benefits from the corporation by making the payments and that as the taxpayer could not have reasonably foreseen that such services would not have been helpful to his business, the payments, though unwise in later years of the contract, were deductible under section 162 of the I.R.C. as ordinary and necessary expenses.

(ii) *Paid Or Incurred During The Taxable Year*

The phrase "paid or incurred" refers to the accounting method of the taxpayer. If a taxpayer is on the cash method, he deducts expenses in the year in which they are paid. If he is on the accrual method, he deducts expenses in the year in which they accrue, namely, when the liability to pay becomes fixed and certain and the amount of the liability is either known or can be estimated with reasonable accuracy. This is so even though the payment may actually be made in a later year or has not been charged to expenses.

Thus in *Globe Gazette Printing Co.* v. *Commissioner,*[40] it was held that salaries of the taxpayer's officers which were authorized in 1918 for the years 1919 and 1921, but which were not paid until 1923, were proper deductions in computing the taxpayer's income for 1919 and 1921, the taxpayer's books of account being kept on the accrual basis. Similarly in *Young* v. *Commissioner,*[41] it was held that certain salaries payments claimed as deductions from the taxpayer's gross income in the years 1921 and 1922, were properly incurred and accruable in such years even though they had not been credited to the personal accounts of the employees concerned or charged to expenses. The Court found as a fact that the liability for the salaries in question was incurred in 1921 and 1922 and indicated that tax liability depended on the facts as found and not on mere book-keeping entries.[42]

However, under section 267(a)(2)(A) of the I.R.C., if the taxpayer reports on the acrual basis and pays compensation to a party who reports on the cash basis, no deduction is allowed the taxpayer if the payment is not made during the taxable year or the succeeding two and one-half months. Section 267(a)(2)(C) of the I.R.C. further states that if the payor and payee are related persons, then no deductions for expenses will be allowed if such

[39](1972) 31 T.C.M. 29.

[40](1929) 16 B.T.A. 161.

[41](1931) 21 B.T.A. 1238.

[42]*Ibid.*, at p. 1241.

relationship exists either at the close of the payor's taxable year or at any time within two and one-half months thereafter. "Related persons" are defined in section 267(b) and (c) of the I.R.C. and include an individual and a corporation, more than 50% in value of the outstanding stock of which is owned directly or indirectly by or for such individual.

The reference to the "taxable year" is in most cases the annual accounting period used by the taxpayer in keeping his books. This is either (i) a fiscal year, namely, any twelve-month period ending on the last day of any month except December or (ii) a calendar year, namely, a twelve-month period beginning January 1st and ending December 31st.

(iii) *Carrying On*

In addition to limiting business deductions to "ordinary and necessary" expenses, section 162(a) of the I.R.C. also requires that the expenses be paid or incurred in "carrying on" any trade or business. The decisive question, then, is: when does a business begin? Regulation 1.248-1 states that "if the activities of the corporation have advanced to the extent necessary to establish the nature of its business operations. . . it will be deemed to have begun business."

In *Seed* v. *Commissioner,*[43] the Tax Court held that a business has begun when the taxpayer has proceeded beyond an initial investigatory stage and has entered a transactional stage. This transactional stage begins at the point where the preliminary investigation has led to the decision to purchase a specific business; but further investigation of the business continues, even if subsequent developments result in abandoning the venture. In this case, the taxpayers, apart from expending funds to secure a charter to incorporate a savings and loan association, had carried out all the requisite steps for its incorporation. The application for a charter was subsequently denied and the venture then abandoned. On the above facts, it was held that a business had begun and that the expense was deductible as a loss incurred in a business transaction under section 165 of the I.R.C.

Where the investigatory expenses are attributable to extending an old business rather than starting a new business, such costs are deductible because a business already exists. In *Colorado Springs National Bank* v. *Commissioner,*[44] the taxpayer bank brought an action for refund of federal income taxes it paid contending that the costs it incurred in participating in the credit card system were deductible under section 162 as business expenses. The Court of Appeal held that where the taxpayer bank adopted a new method to conduct its old business of financing consumer transactions, namely, use of cards and computers, it met the requirements of section 162(a) of the I.R.C. The Court rejected the Government's contention that such expenses were pre-operation costs for entry into a new

[43](1969) 52 T.C. 880.

[44](1974) 505 F. 2d 1185 (10th Cir.).

business. Accordingly, the computer costs, credit checks and promotional activities of the taxpayer's bank in adopting the new method were ordinary and necessary expenses and were deductible.

In the case of investigatory expenses attributable to starting a new business, they are amortizable, at the election of the taxpayer, over five years beginning with the month in which the business begins.[45]

(iv) *Trade Or Business*

The statute and the regulations do not offer a definition of "trade or business" nor has any court clearly spelled out what constitutes a "trade or business". The question is generally one of fact and depends on the circumstances in each case.

In *Higgins* v. *Commissioner,*[46] the Supreme Court has held that the elements of continuity and regularity alone do not, as a mater of law, support a finding of a business if the facts do not so indicate. In the instant case, although the taxpayer engaged in very substantial trading activities in the securities market, it was found by the Court that he did not participate directly or indirectly in the management of the corporation in which he held the stocks or bonds and that the taxpayer merely collected interests and dividends from his securities. The Supreme Court was of the opinion that no amount of personal investment management would turn those activities into a business.

The case of *Lamont* v. *Commissioner*[47] provides further guidance as to when a course of conduct constitutes a trade or business. In this case, the expenses incurred by a taxpayer, who was a wealthy man with an independent income from investment sources, were held not deductible because the taxpayer's activities as a writer and publisher did not constitute a trade or business for the reason that they were not motivated by the intent to realize profits. The Court was of the opinion that the existence of a genuine profit motive is the most important criterion for finding that a given course of activity constitutes a "trade or business" and that though expectation of profit need not be a reasonable one and though the business need not realize immediate profit to justify deductions under section 162 of the I.R.C., nevertheless, the activities must be entered into and be carried on in good faith for the purpose of making profits.

On the facts of the case, the Court found that the totality of circumstances surrounding the taxpayer's background, his interest in the wide dissemination of his ideas, his financial status, justify the conclusion that a profit motive was lacking. The Court also indicated that if such a motive exists coupled with the fact that the taxpayer had conducted his professional activities in a business like manner, paid careful attention to books and

[45] I.R.C. s. 195.

[46] (1941) 312 U.S. 212.

[47] (1964) 339 F. 2d 377 (2d. Cir.).

records; maintained an office, telephone, files or secretary and tried to minimize expenses, then these factors are evidences of an efficient operation and thus, the existence of a trade or business.

That such a profit motive must be the "basic and dominant intention" of the taxpayer is illustrated in *Hirsch* v. *Commissioner.*[48] In this case, the taxpayer, who was president of a packing company and a member of the executive committee of a race track syndicate, sought to deduct, as a worthless debt, a loan made to the syndicate as well as travel and entertainment expenses incurred as a member of the syndicate. In disallowing the claim, the Court found that the race track could not be considered as a trade or business because the basic and dominant intention of the taxpayer was not a desire for profit. The Court was of the opinion that in the absence of a basic and dominant motive to make profit, the taxpayer's activities, no matter how extensive or intensive, could not amount to carrying on a trade or business. Accordingly, the spending of time, money and effort as a corporate executive or in any activity or venture in the general realm of business, does not *per se* put the taxpayer in "business" if the basic and dominant intent behind the taxpayer's activities, out of which the claimed expenses or debts were incurred, is not to make profit or income from those very same activities.

Thus, in activities where there is concededly no profit motive, there is no trade or business, no matter how worthy or extensive the activity. In *White* v. *Commissioner,*[49] the taxpayer had built an expensive ballistics laboratory. As with the taxpayer in *Lamont's* case, this taxpayer was independently wealthy, having received a large inheritance. Although the laboratory performed worthy services for the private industry and the federal government, the taxpayer was not permitted to deduct the losses. The Court found that the ballistics laboratory was not a trade or business because the essential that was missing was a profit motive on the part of the taxpayer.

While the expectation of profit need not be a reasonable one, as was expressed by the Court in *Lamont,* nevertheless it must be a *bona fide* expectation. Such an expectation was, however, not present in the case of *Barcus* v. *Commissioner.*[50] In this case, the taxpayers who were husband and wife, carried on a so-called antique business. The facts as found by the Tax Court showed that the taxpayers used the antiques they were willing to sell as the furnishings of their home and engaged in the purchase and sale of these items more as a way to reduce the cost of living in a home furnished with beautiful antiques than for the purpose of making a profit on their purchase and sale.

The Court in denying the loss deductions from the sale of antiques held that they were not carrying on the business of purchasing and selling anti-

[48](1963) 315 F. 2d 731 (9th Cir.).

[49](1955) 227 F. 2d 779 (6th Cir.).

[50](1973) 42 T.C.M. 660.

ques. Rather, it was to furnish their home. Furthermore, their speculative hope of making a profit at some time in the future indicated more of an interest in keeping the items they have purchased which they considered valuable than it does the making of a profit from a trade or business of purchasing and selling antiques. Thus, while the standard is less than a "reasonable expectation" of making a profit, the intention to try to make a profit must, nevertheless, be a *bona fide* one.

Even if it could be established that a taxpayer is carrying on a trade or business, it is also necessary to show that the expense was incurred in the taxpayer's trade or business. An expense will not be deductible by the taxpayer if it is incurred in the trade or business of another. In *Deputy* v. *Du Pont*, a large stockholder in the Du Pont company acquired additional stock of the company in order to sell it to certain company executives in furtherance of a management incentive plan of the company. The Supreme Court held that the stockholder's expenses in connection with the acquisition were not deductible since they were incurred, not in connection with his trade or business, but in connection with the trade or business of the corporation.

From the discussion of the foregoing cases, it may be possible to define a trade or business as a pursuit in which a profit motive is present and where there is some type of economic activity involved. An activity will be considered a business if it is entered into and carried on in good faith for the purpose of making a profit as opposed to an activity engaged in purely for self-satisfaction. However, in the light of section 212 of the I.R.C., it often will not matter whether the taxpayer is deemed to be engaged in a trade or business or rather in profit-seeking or investment activity since deductions are allowed whichever kind of activity the taxpayer is engaged in.[51]

It is now proposed to examine the following expenses in relation to the deductibility rule:

(a) *Travelling Expenses*[52]

Section 162(a)(2) allows the deduction of travelling expenses, including amounts expended for meals and lodging other than amounts which are "lavish" or "extravagant" while away from home in the pursuit of a trade or business.

In the leading case of *Commissioner* v. *Flowers*,[53] the Supreme Court laid down a three-part test in interpreting section 162(a)(2) of the I.R.C.:

[51] But on occasion it will matter which kind of activity the taxpayer is engaged in. See, for example, s. 280A of the I.R.C. relating to the deduction for an office in the house and ss. 167(a) and 168 of the I.R.C. relating to deductions for depreciation.

[52] See generally Reipen, "Extraordinary Commuting Expenses: Deductibility of Transportation Expenses Between Residence and Temporary Place of Business", (1978) 51 *S. Cal. L. Rev.* 499; Chod, "Travel, Transportation and Commuting Expenses: Problems Involving Deductibility", (1978) 43 *Mo. L. Rev.* 525.

[53] (1946) 326 U.S. 465.

(1) travelling expenses must be necessary and reasonable in amount, appropriate to the carrying on of a trade or business of the taxpayer and must be consistent with the ordinary meaning of the word "travel", which encompasses the major cost of transportation, such as airfare, incidental expenses, such as taxis, tips and meals and lodging while in a travel status.
(2) the expenses must be incurred while the taxpayer is away from home.
(3) The expenses must be incurred in pursuit of a trade or business. This means that there must be a direct connection between the expenditure, and the carrying on of the trade or business of the taxpayer. Moreover, such an expense must be both ordinary and necessary, that is, appropriate and helpful to the development and pursuit of the particular trade or business.

In *Flowers'* case, the facts were that a lawyer, who was employed by a railroad in Mobile, Alabama, lived in Jackson, Mississippi, and deducted the cost of travelling from Jackson to Mobile, including his meals and lodging while at Mobile. The Supreme Court disallowed the deduction on the ground that the said expenses were incurred by the taxpayer for his own convenience and not for business reasons. This was because the taxpayer's employer did not require the taxpayer to live in Jackson. The taxpayer could have lived in Mobile. The Supreme Court, thus, limited its holding to the third test laid down in the case. *Flower's* case can be seen as stating that expenses incurred in commuting between residence and work place cannot be deducted as a travel expense under section 162(a)(2) of the I.R.C.

In order to deduct expenses for travel "away from home", the taxpayer must initially determine where home is. In *Revenue Ruling* 74-432 (1975-2 C.B. 60), it was laid down that, as a general rule, the "tax home" is the place at which the taxpayer conducts his trade or business. Thus in *Hantzis* v. *Commissioner,*[54] a married law student, whose husband remained in Boston, could not deduct the expenses for transportation, meals and lodging incurred while working as a summer associate for a New York law firm because she did not incur those expenses while "away from home" which in this case was New York.

The statutory requirement that the taxpayer be "away from home" before he can deduct his travel, meals and lodging expenses in pursuit of his business was considered by the Supreme Court in *United States* v. *Correll.*[55] In this case, the taxpayer, who was on the road for 12 hours a day but always came home at night, could not deduct his meals incurred during the day. The Supreme Court upheld the Revenue's position that being away from home means that the taxpayer is away overnight or for a period requiring either sleep or rest.

[54](1981) 638 F. 2d 248 (1st Cir.), certiorari denied (1981); 452 U.S. 962.

[55](1968) 389 U.S. 299.

While it is necessary to be away from home overnight in order to be "away from home" for purposes of deducting travelling, meals and lodging expenses, it is possible to stay away from home too long, in which case the taxpayer's home will be deemed to have moved with him. The Service has ruled that where employment at a particular location is anticipated to be, or turns out to be, for a year or more, the employment is not temporary but permanent.[56] In such a case, the taxpayer will not be able to deduct his expenses since he is no longer "away from home". In other words, his "tax home" has now moved to the location of the new employment. However, where the shift is only temporary, the taxpayer's "tax home" remains at its former location and all expenses for travelling, meals and lodging are deductible as travel "away from home". This is because his presence in the temporary location is due to requirement of his business, rather than a personal choice to continue having his home at his former location.[57]

Where the taxpayer, who for reasons of business, has no home at all, but is continuously on the road throughout the year, he will be regarded as "carrying" his home on his back and therefore cannot deduct any of his meals and lodging expenses. In *Rosenspan* v. *United States*,[58] a salesman who travelled ten months of the year but who returned to a hotel in New York City five or six times a year, was denied a deduction for unreimbursed expenses for meals and lodging incurred while travelling on business since he had no home to begin with.

In the light of these principles, it is clear that so long as a taxpayer is already in work status, he can deduct the cost of travelling expenses such as automobile and public transportation expenses incurred between various business locations during the day as ordinary and necessary business expenses under section 162(a) of the I.R.C. However, to deduct any expenses under section 162(a) of the I.R.C. for meals and lodging, the taxpayer must be "away from home" in the sense of being away overnight.

(b) *Expenses Incurred in Attending Conferences*[59]

Expenses paid or incurred by a taxpayer in attending a convention or other meetings, including the cost of travel, meals, lodging and incidental expenses, may be deductible as business expenses, depending on the nature of the taxpayer's business and that of the convention or meeting.[60] In general, the allowance of a deduction for these expenses will depend upon

[56] *Revenue Ruling* 74-291, 1974-1 C.B.-42.

[57] *Commissioner* v. *Flowers* (1946) 326 U.S. 465.

[58] (1971) 438 F. 2d 905 (2d. Cir.).

[59] See generally Postlewaite, "Deductions of Expenses For Conventions and Educational Seminars" (1977) 61 *Minn. L. Rev.* 253; Shaddock, "The Tax Consequences of A Spouse's Convention Expenses", (1977) 29 *Baylor L. Rev.* 585.

[60] Reg. 1.162-2(d).

whether attendance at the convention primarily benefits or advances the interests of the taxpayer's business or trade. If the convention is primarily for political, social or other purposes not directly related to the taxpayer's trade or business, the expenses are not deductible.

The courts have developed at least one method of determining whether attendance at a convention or meeting is primarily for business or social reasons. Under this method, a comparison is made of the taxpayer's duties and responsibilities of his position with the stated purposes of the meeting as shown by the programme or agenda. If the agenda of the convention or meeting is so related to the conduct of the taxpayer's trade or business, that attendance was predominantly for a business purpose, then the "primarily for business" test is satisfied. In *Reed* v. *Commissioner*,[61] expenses incurred by a taxpayer in attending a convention in Yugoslavia as an appointed delegate of the United Stated branch of the International Law Association were disallowed. The Court found that the taxpayer, who was a lawyer, was engaged in a legal practice that was strictly local in nature and concentrated in the areas of wills, trusts and estates. The Court could not find a direct and proximate relationship between the Yugoslav Conference as reflected by its agenda and the taxpayer's local law practice.

In the case of expenses incurred in attending conferences, there is no question of where the taxpayer's home is or that the taxpayer is away from home. But the fact that business and pleasure may be combined on the same trip raises some difficult questions in the tax law.

The expenses of such trips are divided, for purposes of tax analysis, into two parts: the expense of travelling to and from the destination; and the expenses of lodging, meals, etcetera, incurred at the destination. With regard to the former, the Regulations[62] provide an all or nothing approach. The taxpayer's predominant purpose for the trip is crucial since, if the trip is primarily personal in nature, the travelling expenses to and from the destination are not deductible, even though the taxpayer engages in business activities while away from home.[63] Whether a trip is related primarily to a taxpayer's trade or business or is essentially personal in nature, depends on the facts and circumstances of each case. An important factor is the amount of time the taxpayer spends on personal activities in relation to the length of the trip.[64]

As regards the second type of expenses, that is, expenses incurred at the destination, the taxpayer may deduct the cost of meals and loging and other business-related expenses allocable to business activities while at the destination. However, if the taxpayer engages in some personal activity, such as sightseeing, those expenses allocable to non-business activity cannot be deducted.

[61] (1960) 35 T.C. 199.

[62] Reg. 1.162-2(b)(1) and (2).

[63] Reg. 1.162-2(b)(2).

[64] *Ibid.*

In *Rudolph* v. *United States*,[65] a Dallas insurance company, sponsored a "convention" in New York City for insurance agents who had achieved sales above a certain level. Wives were included and all expenses were reimbursed by the company. The Court noted that only one morning of the three-day convention period was taken up with business meetings and concluded that the entire arrangement was a bonus in the form of a paid vacation.

The expenses of a spouse on a business trip are only deductible if the spouse's presence serves a *bona fide* business purpose.[66] The rendering of incidental services or a showing that the spouse was merely helpful to the taxpayer is not sufficient.[67]

It is difficult to state a single rule that will apply to every case in which a spouse's presence can be said to serve a business purpose of the taxpayer. The facts of each case must be examined. In *United States* v. *Disney*,[68] the Court held that the employer's reimbursement of the expenses of the wife's travels was excludable from the employee's gross income on the ground that it had been a long-standing Company policy to insist that spouses accompany executives on business trips to help establish the family image of the company. However, the Court limited the holding to the facts of the particular case, pointing out that the simple fact that an employer pays the cost of a spouse's travel is not determinative of the question of legitimate business purpose.

However, it may be submitted that the cost of the spouse's travel expenses is deductible so long as the spouse's presence is necessary and related to the business of the taxpayer.

In the case of foreign travel,[69] section 274(c) disallows deductions for that portion of the travel which is not allocable to the taxpayer's trade or business or profit-seeking activity. To the extent some of the taxpayer's time at the foreign destination is spend on personal activities, some portion of the expenses for travelling to and from the destination will be disallowed.[70] The allocation of expenses is made by multiplying the taxpayer's total travel expenses by a fraction, the numerator of which is the number of non-business days and the denominator of which is the aggregate of business and non-business days.[71] The result is the amount considered "personal" and therefore not deductible. The restriction of section 274(c) on travel to and from a foreign destination does not apply if the travel

[65](1962) 370 U.S. 269.

[66]Reg. 1.162-2(c).

[67]*Ibid.*

[68](1969) 413 F. 2d 783 (9th Cir.)

[69]For purposes of this rule, United States possessions such as Puerto Rico and the Virgin Islands are considered "foreign". (Reg. 1.274-4(a)).

[70]Reg. 1.274-4(f)(5) and see Reg. 1.274-4(g) for further qualifications.

[71]Reg. 1.274-4(f)(i)(ii)(iii).

[72]I.R.C. s. 274(c)(2)(A), (B).

does not exceed one week or if the taxpayer spends less than 25 per cent of his total time on non-business activities.[72]

With regard to foreign conventions, section 274(h) provides, in substance, that no deduction will be allowed the taxpayer for expenses incurred in attending a convention, seminar or similar meeting held outside the "North American Area"[73] unless the taxpayer can establish that the meeting is directly related to the active conduct of the taxpayer's trade or business or to an income-producing activity within the meaning of section 212 and that it is as reasonable[74] for the meeting to be held outside the North American area as within it. Where the convention is held on a cruise ship, a deduction will be allowed[75] if the taxpayer establishes that the meeting is directly related to the active conduct of his trade or business or to an activity within the meaning of section 212 and if he complies with the strict substantiation rules in section 274(h)(5). In addition, the cruise ship must be a vessel registered in the United States and all ports of call of such cruise ship are located in the United States or its possessions.[76]

(c) *Entertainment, Amusement and Recreation Expenses*

Section 27(a) of the I.R.C. disallows deductions with respect to activities which are of a type generally considered to constitute entertainment, amusement or recreation,[77] unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and *bona fide* business discussion, that the item was associated with the active conduct of a taxpayer's trade or business.[78]

Entertainment expenses are considered "directly related" to the active conduct of a taxpayer's trade or business if any of the following requirements are satisfied.[79] First, if at the time the taxpayer made the entertainment expenditure, there was more than a general expectation of deriv-

[73]The term "North American Area" means the United States, its possessions, the trust territories of the Pacific Islands, Canada and Mexico.

[74]The factors to be considered in determining reasonableness are (i) the purpose of the meeting and the activities taking place at the meeting (ii) the purposes and activities of the sponsoring organization (iii) the residences of the active members of the sponsoring organization and the places at which other meetings of the sponsoring organization have been or will be held (iv) other relevant factors (s. 274(h)(1)(A), (B), (C), (D)).

[75]I.R.C. s. 274(h)(2).

[76]I.R.C. s 274(h)(2)(A), (B).

[77]Reg. 1.274-2(b)(1)(i) defines entertainment, amusement or recreation as ranging from business meals to treating guests to night clubs, country clubs, theatres, sporting events, or providing hunting, fishing and similar trips. However, a number of business-oriented entertainment expenses are not subject to the disallowance provision of s. 274(a) and are deductible, if substantiated, under s. 162. These expenses include business meals, food and beverages for employees, recreational expenses and business meeting expenses (s. 274(e) and Reg. 1.274-2(f)(2)(e).

[78]It is to be noted that the disallowance provisions of s. 274(a) does not apply if the expense is not otherwise deductible under s. 162(a).

[79]Reg. 1.274-2(c)(3).

ing some income or other trade or business benefit, other than goodwill, at some indefinite future time, the expenditure will be considered "directly related."[80] In *Thompson* v. *Commissioner*,[81] the Tax Court disallowed expenses for annual hunting trips paid by the owner of a sole proprietorship who thought the trips might create goodwill and, eventually, business. Second, an entertainment expenditure is directly related to the active conduct of the taxpayer's trade or business if the entertainment occurred in a "clear business setting" directly in furtherance of the taxpayer's trade or business.[82] For instance, expenditures made to provide a "hospitality" room at a convention at which goodwill is created through the display of the taxpayer's products are directly related. Third, the "directly related" test is satisfied if it is established that the expenditure was made directly or indirectly by the taxpayer for the benefit of an individual, other than an employee, and if the expenditure was in the nature of compensation for services rendered or was paid as a prize or award.[83] Thus, if General Motors provides a trip to Hawaii for the top producing dealers in its retail sales network, and the value of the trip is includable in the dealers' gross income, the expenditure is directly related to the active conduct of General Motors' trade or business. Fourth, an entertainment expenditure is directly related if it was made with respect to a facility used by the taxpayer for the furnishing of business meals.[84]

However, the "directly related" test will not be satisfied if (i) the taxpayer is absent, (ii) the distractions are substantial where, for example, the meeting is held at a night club, theatre, or sporting event or (iii) the taxpayer meets with a group that includes persons other than business associates at places such as country clubs or golf courses.

The second test under section 274(a) is the "associated with" test. Any entertainment expenditure is considered "associated with" the active conduct of the taxpayer's trade or business if there existed a clear business purpose in making the expenditure[85] such as to obtain new business or to encourage the continuation of an existing business relationship. For example, a dress manufacturer who entertains department store buyers after the placing of an order is making an entertainment expenditure that is clearly associated with the active conduct of the trade or business. This would also be the case if the entertainment occurred on the night preceding the business discussion and involved the buyers and the spouses.[86]

[80] Reg. 1.274-2(c)(3)(i).

[81] (1979) 39 T.C.M. 728.

[82] Reg. 1.274-2(c)(4).

[83] Reg. 1.274-2(c)(5).

[84] Reg. 1.274-2(c)(6).

[85] Reg. 1.274-2(c)(2).

[86] Reg. 1.274-2(c)(3).

It is to be noted that under the "associated with" test, the entertainment must directly precede or follow a substantial and *bona fide* business discussion. Thus in *Lennon* v. *Commissioner*,[87] the cost of a birthday party was disallowed under section 274(a) even though two-thirds of the guests were law partners and clients. The Tax Court found that the business discussions during the three months preceding and following the party "did not directly precede or follow" it.

With regard to entertainment facilities (such as country clubs, sporting lodges), the general rule is that no deduction is allowed with respect to the use of such facilities in connection with entertainment even though such deduction would qualify as an ordinary and necessary business expenses under section 162 of the I.R.C.[88] This disallowance of expenses also applies to dues or fees paid to any social, athletic or sporting club.[89]

However, clubs operated solely to furnish lunches in a business setting are exempted from this disallowance.[90] Furthermore, if the taxpayer establishes that in the case of a club, the facility was used primarily for the "furtherance of the taxpayer's trade or business" and that the amount paid was "directly related" to the active conduct of such trade or business, the disallowance will not apply.[91] In the case of a club, it will not be considered used primarily in furtherance of the taxpayer's business unless more than 50 per cent of the days of use during the taxable year are devoted to business.[92]

It should be noted that under section 274(d) of the I.R.C., all deductions for travel away from home and entertainment expenses must be substantiated[93] by adequate records or sufficient evidence corroborating the taxpayer's own statement as to the amount, time and place of the travel and entertainment and the business purpose of the expenses. Thus, the rule established in *Cohan* v. *Commissioner*[94] is not available to taxpayers for travel and entertainment expenses. In this case, the Court ruled that a taxpayer who is able to establish that substantial sums were spent in a deductible activity, but who is unable to specifically document the amount of the expenditure, is nevertheless entitled to some deduction based on the best available under the circumstances.

However, the *Cohan* rule is still applicable to local transportion expenses, which are not covered by section 274(d) of the I.R.C. Nevertheless, such

[87](1978) 37 T.C.M. 751.

[88]I.R.C. s. 274(a)(1)(B).

[89]I.R.C. s. 274(a)(2)(A).

[90]Reg. 1.274-2(e)(3)(ii).

[91]I.R.C. s. 274(a)(2)(C).

[92]Regs. 1.274-2(e)(4)(iii)(a) and 1.274-2(e)(4)(iii)(b).

[93]The substantiation requirements are set out in detail in Reg. 1.274-5(b) & (c).

[94](1928) 11 B.T.A. 743, reversed (1930); 39 F. 2d 540 (2d Cir.).

expenses must still comply with Regulations 1. 162-17(d)(2) and (3), which require a taxpayer to maintain such books and records as will be sufficient to enable the Commissioner to correctly determine the income tax liability but which allow for approximations when records are incomplete or unavailable. The only limitation is that the claimed expenses must be reasonable in view of the taxpayer's income and occupation.

From the foregoing discussion, a number of conclusions may be made of the Malaysian and United States tax provisions.

First, it is to be noted that an expense to be deductible under section 162(a) of the I.R.C. must not only be ordinary but must also be shown to be necessarily incurred in carrying on any trade or business. On the other hand, under section 33(1) of the Malaysian Act, for an expense to be deductible, it is sufficient to show that it was incurred "wholly and exclusively", that is, solely, in the production of income without the additional requirement that the expense must also be shown to be one which is necessary to be incurred. As has already been noted, the phrase "wholly and exclusively" is not as restrictive as it seems but has instead been interpreted by decided cases as importing the notion of apportionment wherever applicable. Although the use of the word "necessary" seems to suggest that the scope of section 162(a) of the I.R.C. is more restrictive as compared with that of section 33(1) of the Malaysian Act, it has, however, not been narrowly applied by the United States courts. This is borne out by cases such as *Fumigators Inc.* v. *Commissioner* and *Welch* v. *Helvering* where in the latter case, the Supreme Court opined that the taxpayer's judgment as to what is a necessary expense is generally accepted by the courts.[95] Accordingly, section 162(a) of the I.R.C. is not narrower than section 33(1) of the Malaysian Act in this respect.

Another difference to note is that section 33(1) of the Malaysian Act stipulates that an expense is deductible if, *inter alia,* it is incurred "in the production of income." Section 162(a) of the I.R.C., on the other hand, provides that an expense is deductible if, *inter alia,* it is incurred "in carrying on any *trade* or *business.*"[96] As will be recalled, Lord Morton in *Morgan* v. *Tate and Lyle*[97] expressed the view that the phrase "in the production of *income*" as found in section 86(1)(a) of the then New Zealand Land and Income Tax Act, 1954 (which is substantially similar to section 33(1) of the Malaysian Act) is narrower than the phrase "for the purposes of the trade or business" employed in section 130(a) of the United Kingdom Act. This view was upheld by the Privy Council in *Ward & Co. Ltd.* v. *Commissioner of Taxes*[98] where Viscount Cave pointed out that there is

[95](1933) 290 U.S. 111 at p. 113.

[96]In the event that an expense is held not to fall within section 162(a) of the I.R.C. because there is no trading or business activity, a deduction may still be available under section 212 of the I.R.C.

[97](1954) 35 T.C. 367 at p. 412.

[98][1923] A.C. 145.

a difference between expenditure incurred for the purpose of carrying on a business from which the income is produced and expenditure incurred for the production of income. However, it is submitted that there is no appreciable difference because expenses incurred for the purpose of carrying on a business from which the income is produced are, for all practical purposes, also incurred for the production of income. In other words, it is only from the carrying on of a trade or business that the income in question is derived. In the light of this observation, it is submitted that the scope of the phrase "in the production of income" in section 33(1) of the Malaysian Act is not narrower than that of the phrase "in carrying on any trade or business" in section 162(a) of the I.R.C.

However, both the United States and Malaysian provisions allow for the deduction of expenses paid or incurred in the relevant taxable year. Incurred is taken to mean, in the case of a taxpayer who adopts the cash basis, money actually laid out during the taxable year in question and in the case of a taxpayer who adopts the accrual basis, money for which a legal liability to pay has arisen and become fixed at the end of the relevant taxable year even though the payment may actually be made in a later year.

It is also clear that in the case of travelling expenses, both the Malaysian and United States provisions adopt the rule that the cost of travelling between one's residence and the place of work would be disallowed as being personal. However, the moment one is in work status, the expenses incurred in travelling between two working places are deductible. However, in the United States this is subject to the requirement that meals and lodgings would only be allowed if the travelling is overnight and is in pursuit of trade or business. In practice, the Department of Revenue in Malaysia adopts the same position.

It is also clear from the cases discussed above, that travelling expenses incurred between home and place of work may be allowable if the taxpayer's home can be said to be his base of operations.

It is to be noted that the difficulties arising in connection with the deductibility of commuting expenses are due to the fact that such expenses often involve elements of both the costs of earning income and personal consumption. In denying a deduction of expenses of travelling between home and work, the present law treats them as a form of personal consumption. It may be argued the they ought not to be so treated since they are a prerequisite to the earning of income. But the same could be said of many other expenses whose deduction are currently denied, such as outlay on basic food, clothing and shelter. Accordingly, a deduction for expenses of travelling between home and place of work can only be justified as a concession.[99]

[99]See generally, Chod, "Travel, Transportation and Commuting Expenses: Problems Involving Deductibility", (1978) 43 *Mo. L. Rev.* 525; Klein, "Income Taxation and Commuting Expenses: Tax Policy and the Need for Nonsimplistic Analysis of 'Simple Problems'", (1969) 54 *Cornell L. Rev.* 871.

The case for giving a concessional deduction in this area would have to rest on the fact that the incidence of such expenditure, unlike on basic necessities, varies between individuals in a way that cannot be wholly explained by personal preference. This may arise because one taxpayer faces high costs of travel while another does not. The former may live far from his place of work, or may be forced to use expensive means of transport because public transportation is not available at all or not available when he has to travel, for example, in the case of shift worker.[100]

However, notwithstanding this argument, it is submitted that a large element of personal choice enters into a taxpayer's decision where he will live and where he will work. In other words, the taxpayer has a clear choice between more expensive housing plus modest travel expenses and less expensive housing plus considerable travel expenses. One taxpayer may live further from his work place for the sake of lower living costs or other advantages for himself and his family while another may live nearer but at a higher cost in other respects. Moreover, if a taxpayer chooses to spend, say, $80.00 a month travelling to and from his home in a distant suburb, this expenditure is similar to that of another who pays $80.00 a month more rent to live close to his place of work. Accordingly, there is a wide range of choice of exact location. Since the tax system does not take account of the variations in living costs and other advantages, the better rule is to refuse any allowance for such cost of travel.

Even if it could be argued that the shortage of living accommodation which has prevailed in recent years gives some artificiality to the argument that a man has freedom of choice to determine where he will live in relation to his work, to identify these cases would involve an impossible administrative burden. The basic difficulty is that there are no clear lines of distinction and each case would require an elaborate inquiry.

Assuming that if a general deduction were to be allowed, some control would have to be imposed on the amount deductible so as to deny a deduction of extravagant expenditure. One possibility would be to limit the deduction to expenses in fact incurred in using public transport. But this would lead to inequities between taxpayers who are in a position to use public transport and taxpayers who are not. A way of overcoming this problem would be to allow expenses of other modes of travel where public transport is not available but to limit the deductions to some notional amount that might be thought reasonable in the circumstances. However, there would be administrative problems in fixing such notional amounts and also the element of arbitrariness. Other administrative problems would be in assessing the expenses of the private transport adopted such as a motor vehicle in respect of which running costs and depreciation would be claimed.

[100] See United Kingdom, *Royal Commission on the Taxation of Profits and Income, Final Report* (1955) Cmd. 9474 Paras. 236-237 (hereinafter referred to as the *Radcliffe Commission Report)* and Canada, *Report of the Royal Commission on Taxation* (1966) Vol. 4 at page 231 (hereinafter referred to as the *Carter Commission Report).*

Accordingly, the foregoing analysis suggests that any proposed deduction for commuting expenses would be undesirable because of the administrative difficulties involved and the fact that a great part of these expenditures seem to represent personal consumption expenses in regard to living arrangements. Thus, the long-standing rule against the deduction of regular commuting expenses seems justified and proper.

In regard to expenses of travel between two places of work, they are properly allowable as deductions as they are incurred in deriving income. Nevertheless, in the United States, meals and lodging expenses incurred in connection with travel do not qualify for deductions unless the taxpayer is away overnight.[101] The overnight rule is simply a device for making the necessary distinction between everyday living expenses on the one hand, and on the other, "travel".

In regard to such subsistence expenses as meals and lodging incurred overnight, an argument could still be made that the taxpayer should, nevertheless, be allowed only the excess by which the amount that he has been obliged to spend in the performance of his duties exceeds what he would have spent otherwise. In other words, the taxpayer's allowable expenses is arrived at by setting off against his gross outlay, a notional amount to represent the moneys that he would have spent on living and accommodation if his duty has not required him to be absent from his home. While it is true that if a taxpayer is absent from his home on business for a substantial period, there are some savings in the house, it is equally clear that his absence will involve additional expenses in other ways and it is a real defect in this argument that, while it claims to take account of all savings, it refuses to allow any recognition of additional expenses.[102] Moreover, there are no means by which such savings can be satisfactorily determined.[103] Accordingly, the better rule would still be to allow, in full, the subsistence expenses proved to be incurred in deriving income.

In regard to mixed business and pleasure travel expenses, including attendance at conferences, both the Malaysian and United States provisions appear to adopt the same position, with the United States provision (read together with the Regulations) being more detailed and elaborate. Generally, both the Malaysian and United States provisions require that the trip must be undertaken primarily for a business purpose. Otherwise, the travelling expenses incurred will not be allowed as such expenses will be regarded as incurred for a dual purpose and so not "wholly and exclusively" incurred in the production of income under section 33(1) of the Malaysian Act. Under section 162(a) of the I.R.C. (read together with the Regulations[104]), such expenses would not be regarded as "directly connected with or pertaining to the taxpayer's trade or business".

[101] *U.S.* v. *Correll* (1967) 389 U.S. 299.

[102] *Radcliffe Commission Report*, *op. cit.*, paras. 229-231.

[103] *Ibid.*, at para. 231.

However, if the expenditure so incurred can be apportioned into allowable and non-allowable parts, then an allocation may be made under the Malaysian position on the authority of decided cases discussed above. Under the United States position, the approach is also to allocate the expenses incurred at the destination regardless of whether the expenses of getting to and from the destination are deductible or not. However, substantiation is required of the expenses sought to be deducted as a matter of practice in Malaysia and by virtue of section 274(d) of the I.R.C. in the case of the United States.

As for entertainment expenses, both the Malaysian and United States positions generally require that the business motive in incurring the expense must predominate. Like commuting expenditures, entertainment expenses include both personal consumption and cost elements but have received more liberal treatment under the Malaysian law than commuting expenditures. As will be recalled, under the Malaysian position, the courts have given a liberal interpretation of the phrase "wholly and exclusively" in regard to entertainment expenditure. Such expenditure is deductible if the sole object in incurring the expenditure is business promotion although an element of hospitality may be involved.[105] Even where there is a motive independent of the business purpose to be served, so that the expenditure is not wholly and exclusively incurred for business purposes, the expenditure incurred may still be apportioned into allowable and non-allowable parts.[106] Moreover, in many instances, the amount of the allowance has been negotiated by taxpayers with the Revenue. This results, inevitably, in inconsistencies and is also opened to abuses which are difficult to police.

In the United States, the law requires a substantial degree of detailed recording of the precise nature of travel and entertainment expenditure and the vouching of such expenditure.[107] It is submitted that similar provisions be included in the Malaysian law. In the absence of such recording and vouching, deduction for travel and entertainment expenditure should be denied. The recording of entertainment expenditure would, for example, require specification of the date, place, and description of the persons being entertained. It would be necessary to set some limit on the amount of any individual expenditure below which vouching would not be required. However, in the United States itself, despite such substantiation requirements, there are still difficulties in determining whether travel and entertainment expenses are necessary business costs and reasonable in amount. The question whether a particular trip or entertainment activity is required by business considerations, though subject to some objective tests such as the "primary purpose" test and the "directly related or

[104] Regs. 1.162-1(a) and 1.162-2(a) - (b).

[105] *Bentleys, Stokes and Lowless* v. *Beeson* (1952) 33 T.C. 491.

[106] *Copeman* v. *Flood* (1940) 24 T.C. 53.

[107] I.R.C. s. 274(d).

associated with" test, is largely a matter of judgment.[108] Most travel and entertainment expenses are for items that, unless for a business purpose, would be classified as personal consumption. Even when the activity serves a business purpose, the taxpayer may receive personal benefits.

For persons subject to high tax rates, there is a temptation in treating personal expenses as deductible. It may be noted that in close cases, the "primary purpose", "directly related" or "associated with" tests employed in the Regulations, are likely to result in hair-splitting at the audit level and may prove arbitrary such that Revenue agents, with the greatest objectivity possible, may not interpret these Regulations uniformly with the result that illegitimate deductions will be allowed and legitimate ones disallowed. In the latter case, the taxpayer may resort to cheating or manipulation to secure their deductions. The obvious result of a complicated and excessively detailed legislation such as section 274 and the accompanying Regulations issued thereunder, must be controversy at the audit level and, in turn, extensive litigation. Thus, the difficulty of auditing a claimed deduction which is enhanced by the subjectivity of the distinction between necessary costs of earning income and personal consumption, is not lessened, in any great measure, by the enactment of section 274(d) of the I.R.C. This is because, in overall terms, the impact of section 274(d) is chiefly in respect to the requirement of documentation.

Accordingly, despite the fact that the I.R.C and the Regulations issued thereunder imposed stringent standards on the deduction of entertainment expenses and strengthened requirements for substantiation and record-keeping, these standards are, nevertheless, insufficient in practice to prevent all improper deductions of travel and entertainment expenses. The most promising approach may still be that as suggested by the United States Treasury Department in 1961, namely, the denial of deductions for whole categories of entertainment expenses and the establishment of maximum allowances for meals and lodging.[109] Similarly, more stringent provisions for allocating travel costs between business and personal purposes seem proper. Such an approach seems justified as present rules and procedures covering travel and entertainment expenses do not succeed in limiting deductions necessary costs of earning income and stricter standards are needed to check tax avoidance in this area.

In regard to legal fees incurred by the owner of a business in appealing against a tax assessment to the Revenue, under existing Malaysian law, they are not allowable deductions in computing the business profits, notwithstanding that the point of the appeal may be connected with the ascer-

[108]See Axelrad, "An Evaluation of the New Rules Relating to the Deductibility of Entertainment, Travel and Gifts: A Critical Look At S. 274", (1964) 16 *U.S. Cal. Tax Inst.* 345; Emmanuel and Lipoff, "Travel and Entertainment: The New World of S. 274", (1963) 18 *Tax L. Rev.* 487.

[109]United States Treasury Department, *Study on Entertainment Expenses,* Hearings before the Senate Committee on Finance, 87 Congress 2d Session (1962) part 1, pp. 270-277. This study includes a review of administrative experiences, and analysis of Court decisions and a compilation of comments in newspapers and magazines.

tainment of those profits.[110] The rationale is that such expenses are expenses not of earning the profits but of determining the share to which the Revenue was entitled. Another argument against permitting such a deduction would be that disputes often arise on tax matters unconnected with the ascertainment of business profits, for example, on personal allowances, and if owners of businesses were allowed to treat as business expenses, costs incurred in connection with tax appeals, they would be getting preferential treatment as compared with other taxpayers. However, it may be recognized that such costs are a consequential expense incurred in the course of carrying on a business[111] and accordingly, they should be allowable in computing business profits so long as they are incurred solely with the objective of ascertaining the profits of the business. It is to be noted that in the United States, litigation expenses incurred with respect to any tax controversy arising out of the taxpayer's business are allowable as a business expense under section 162(a) of the I.R.C., absent public policy considerations.[112]

D. *Judicial Interpretation: Limitations On Deductions Generally*

Notwithstanding the variety of deductible items prescribed under both the Malaysian and United States tax provisions, there are a number of expenditures which appear to arise out of business activity whose deductibility can still be in question. There are several broad principles that may apply to such items which have the effect of preventing them from being deducted even though they are expenditures arising out of business activity. Amongst the major principles are that expenditures may be non-deductible if they are personal in nature or that they are capital expenditures. Expenditures may also be non-deductible because they violate public policy. Taken together, these limitations on deductions cover a wide variety of expenditures and transactions as the discussion below indicates.

(i) *Personal Expenditure*

A fundamental principle shared by both the Malaysian and United States tax systems is that no deduction is allowed for personal expenses. Under section 39(1)(a) of the Malaysian Act, it is provided that no deduction shall be allowed in respect of domestic or private expenses. Similarly, section 262 of the I.R.C. provides that no deduction shall be allowed for personal, living or family expenses.[113] Thus, any expense of a purely personal nature, such as the cost of food for the taxpayer and his family, commuta-

[110] *Smith's Potato Estates Ltd.* v. *Bolland* [1948] A.C. 508.

[111] See Grishman, "Deductibility of Legal Expenses For Federal Income Tax Purposes", (1974) 26 *U.S. Cal. Tax Inst.* 875; Brookes, "Litigation Expenses and the Income Tax", (1957) 12 *Tax L. Rev.* 241.

[112] *Trust of Bingham* v. *Commissioner* 325 U.S. 365 at p. 376.

[113] See generally Halperin, "Business Deductions For Personal Living Expenses: A Uniform Approach to an Unsolved Problem", (1974) 122 *U. Pa. L. Rev.* 859.

tion, including travel to and from the taxpayer's place of work[114] and general household expenses, although in some cases necessitated by business reasons, does not rank for deduction and is specifically prohibited.

Most expenditure which a taxpayer makes can be viewed as having both a personal component (and hence regarded as nondeductible) and as having a business expense component (and hence regarded as deductible). Personal items, such as food, has its business component, since a taxpayer cannot work without nourishment. Accordingly, lines must be drawn and rules must be made to prevent all expenses of living from being deductible in full.

How the courts assist in the task of drawing the lines may be seen in the following cases. In *Norman* v. *Golder*[115] the facts were that a shorthand writer had suffered from a severe illness and had incurred medical expenses in that connection. He claimed, as deductions, medical expenses incurred by him on the ground that as his illness was the direct result of working in unfavourable conditions, the expenses of his illness should be deductible by him in computing his professional profits as they were wholly and exclusively incurred in connection with his professional work. The Court of Appeal disallowed the claim, holding that the expenses incurred were personal in nature. Lord Greene M.R. said,

> "It is quite impossible to argue that doctor's bills represent money wholly and exclusively laid out for the purposes of the trade, profession or employment of the patient. True it is that if you do not get yourself well and so incur expenses to doctors, you cannot carry on your trade or profession, and if you do not carry on your trade or profession you will not earn an income, and if you do not earn an income, the Revenue will not get any tax. The same thing applies to the food you eat and the clothes that you wear. But expenses of that kind are not wholly and exclusively laid out for the purposes of the trade, profession or employment. They are laid out in part for the advantage and benefit of the taxpayer as a living human being."[116]

In the United States, the courts have held similar views in respect of the following types of expenses. In the leading case of *Smith* v. *Commissioner*,[117] a married couple, both of whom worked, incurred expenses for a nursemaid to take care of their young child. It was clear that had the wife not worked, there would have been no necessity to hire the nursemaid. Thus, the case for deducting the nursemaid expenses was stronger than the case for deducting the cost of the couple's rent or food, expenses for which would have been incurred whether or not both husband and wife worked. However, the Court denied the couple's claim for deduction of the nursemaid expenses on the ground that the expenses were

[114] See pp. 140-143, 155-157 for a discussion of the cases involving travelling expenses.

[115] (1944) 26 T.C. 293.

[116] *Ibid.*, at p. 299.

[117] (1939) 40 B.T.A. 1038.

inherently personal and of a character applicable to human beings generally. The Court said,

> "Petitioners would have us apply the 'but for' test. They propose that but for the nurses the wife could not leave her child; but for the freedom so secured she could not pursue her gainful labors; and but for them there would be no income and no tax. This thought evokes an array of interesting possibilities. The fee to the doctor, but for whose healing service the earner of the family income could not leave his sickbed; the cost of the laborer's raiment, for how can the world proceed about its business unclothed; the very home which gives us shelter and rest and the food which provides energy, might all by an extension of the same proposition be construed as necessary to the operation of business and to the creation of income. Yet these are the very essence of those 'personal' expenses the deductibility of which is expressly denied. . . ."[118]

In relation to housekeeping and child-care expenses, the present law in Malaysia is that such expenses are not deductible. It is submitted that the failure to allow the deduction of these costs in the computation of taxable income constitutes a bias against outside employment. While it may be argued[119] that these costs are diverse and indistinguishable from ordinary consumption and that they are also incurred by families in which the wife does not work outside the home so that it would be impossible to draw a satisfactory distinction between ordinary consumption and additional expenditures that are costs of earning income, it is submitted that there should be some concession in the law, not because of any policy of encouraging persons with responsibilities to children to seek employment, but in order that those who are employed, whether through choice or necessity, might be assisted in meeting the costs of discharging the responsibilities of caring for children when the services of others must be employed. The need for a concession will be the less if the government provides child-care facilities directly by way of free or subsidized day-care centres and the like. However, it cannot be anticipated that such facilities will ever be universally available.

In the United States, there is a provision[120] directed towards the giving of a credit for the care of children and others in the taxpayer's household incident to the holding of a job by the taxpayer under certain conditions. The main requirement is that the child-care expenses are necessary for the

[118] *Ibid.*, at pp. 1038-9. For the present credit allowed in connection with child care expenses, see s. 44A of the I.R.C. For literature in this area, some of it dealing with the limited deduction for child care that preceded the childcare credit, see Bittker, "Federal Income Taxation And The Family", (1975); 27 *Stan. L. Rev.* 1384; Feld, "Another Word On Child Care", (1973) 28 *Tax L. Rev.* 546; Schaffer and Berman, "The Child Care Deduction And The Progressivity of the Income Tax: A Reply to Professor Feld", (1973) 28 *Tax L. Rev.* 549.

[119] See Schreiber and Young, "Childcare Expenses: A Proposal For A More Equitable and Efficient Tax Treatment", (1976) 54 *Taxes* 345; Parr, "Section 504 Of The Tax Reform Act of 1976: The New Credit For Child Care Expenses", (1977) *Tax Law.* 546.

[120] I.R.C. s. 44A.

taxpayer to be employed or to seek employment. The child must be a dependant under 15 years of age for whom the taxpayer is entitled to claim a dependancy exemption,[121] or if the dependant is over that age, he must be physically or mentally disabled.[122] The credit is also available to married couples where both are gainfully employed or where one spouse is disabled.[123] The credit is 30% of employment-related expenses[124] for taxpayers with adjusted gross incomes of $10,000 or less. The percentage credit decreases by 1% for each $2,000 (of fraction thereof) increase in adjusted gross income. The credit does not decrease below 20%. Therefore, taxpayers with adjusted gross income of $28,000 or more receive a credit of 20% of employment-related expenses.[125] Expenses are not given a credit if paid to a person for whom the taxpayer is allowed a dependancy deduction or who is a child of the taxpayer under the age of nineteen.[126]

In view of the United States system of giving a credit for child-care and housekeeping expenses and for the reasons advocated above, it is recommended that under the Malaysian law, a concession be made available to a married couple both of whom are working, to a married couple where one works and the other is an invalid and to the head of a one-parent household who works. Admittedly, a number of questions arise as to the scope of the concession. These relate to the nature of a qualifying expense, the amount of expense that may be recognized in respect of each child, the age at which the concession ceases, the scaling down of the expense where the earning of income is on a part-time basis or exends to only part of the year and the protection of the Revenue when the expense involves payment to a relative. Thus, although household and child-care expenses would seem to be predominantly personal consumption expenses, nevertheless, a credit given to working spouses in this regard would be defensible in recognition of the existence of costs that cannot be accurately measured.

In *Pevsner* v. *Commissioner*,[127] clothing bought by a taxpayer saleswoman to work in a boutique, was held to be a non-deductible personal expense even though she lived simply and did not wear them off the job. The Court applied an objective test to determine whether the clothing was suitable for general or personal wear. Under such a test, the matter of suitability was to be judged not by reference to the taxpayer's lifestyle

[121] I.R.C. s. 44A(c)(1)(A).

[122] I.R.C. s. 44A(c)(1)(B).

[123] I.R.C. s. 44A(c)(1)(C).

[124] "Employment-related expenses" means amounts paid to enable the taxpayer to be gainfully employed which are for household services and expenses for the care of a qualifying individual whether the expenses are for care, inside or outside the home, as long as the qualifying individual regularly spends at least 8 hours a day in the taxpayer's household (I.R.C. s. 44A(c)(2)(C)).

[125] I.R.C. s. 44A(a)(1) and s. 44A(a)(2).

[126] I.R.C. s. 44A(f)(6).

[127] (1980) 628 F. 2d 467 (5th Cir.).

or personal taste but instead by what is generally accepted for ordinary street wear. The Court came to the conclusion that they were suitable for personal wear as they were adaptable for general usage as ordinary clothing. Morever, the taxpayer was not prohibited from using them as such. Accordingly, the expenses incurred were held to be personal in nature.

In another case, *Reading* v. *Commissioner*,[128] the taxpayer sought to deduct expenses incurred in respect of the following items: (i) cost of water, sewer, electric and telephone services for the house (ii) food for his family (iii) cost of tuition and books for his two minor children (iv) personal upkeep in respect of clothing expenses, gasoline and small purchases of household furniture. The taxpayer asserted that his true income from the sale of labour cannot be determined until his investment in that labour has been recovered by subtracting the expenditures at issue from the amount received from the sale of labour. In rejecting the taxpayer's claim on the ground that the items sought to be deducted were personal, living and family expenses, the Court said,

> "One's living expenses simply cannot be his "cost" directly in the very item sold, i.e. his labor, no matter how much money he spends to satisfy his human needs and those of his family. Of course we recognize the necessity for expenditures for such items as food, shelter, clothing, and proper health maintenance. They provide both the mental and physical nourishment essential to maintain the body at a level of effectiveness that will permit it's labor to be productive. . . But the sale of one's labor is not the same creature as the sale of property and whether the distinction comports with petititioner's philosophical rationalization for his argument, it is recognized for Federal income tax purposes. One's gain from the sale of his labor is the entire amount received therefore without any reduction for what he spends to satisfy his human needs."[129]

In the light of the foregoing cases, it is clear that one approach in drawing the line between personal and business expenses is to deny a deduction for expenditures which represent the very basic living expenses which a living human person must incur (such as shelter, cost of food for the taxpayer and his family), whether or not he works. In other words, expenses which are common to everyone, employed and non-employed, are not deductiductible. Another approach in drawing the business-personal line, as was noted in the area of travel and business entertainment expenses, is to determine whether the expense was incurred primarily for a business purpose and where the personal benefit was merely incidental. Where the expense is so incurred, it will normally be allowed in full. A third approach would be to allocate the expenditure incurred for a dual purpose, with the portion attributable to the business purpose being deductible.

[128](1978) 70 T.C. 730.

[129]*Ibid.*, at pp. 732-3.

However, it is clear that no satisfactory line can be drawn to distinguish between business expenses and personal expenditures. This is because there will always be, on the one hand, nondeductible items that contribute in some way to the production of income and, on the other hand, deductible items that confer "personal" benefits on the taxpayer. At best, the line may be drawn with the aid of the approaches suggested above.

(ii) *Capital Expenditure*

Generally, under both section 39(1)(e) and section 263 of the Malaysian Act and the I.R.C. respectively, no deduction is allowed for capital expenditures which are, in general, the cost of acquisition, construction or erection of buildings, machinery and equipment which have a useful life substantially beyond the taxable year.[130] Instead of being deducted immediately, such expenditures are, if the property is depreciable, depreciated over the property's useful life.[131] If the property is not depreciable, such as stock and goodwill, the benefit of a capital expenditure deduction will only be available upon the sale of the property.[132]

Whether a particular item is a capital expenditure or business expense (and hence deductible under section 33(1) and section 162 of the Malaysian Act and the I.R.C. respectively) is a question of fact. Although the distinction between capital expenditure and revenue expenditure is not always easy to draw, some of the more important tests which have been applied to make the distinction are reflected in the following United Kingdom cases.

In *British Insulated and Helsby Cable Ltd.* v. *Atherton,*[133] Lord Cave formulated a general statement as to when expenditure is capital. His Lordship said,

> "Where an expenditure is made not only once and for all but with a view to bringing into existence an advantage for the enduring benefit of a trade, there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital."[134]

[130] Reg. 1.263(a)(-1(a) of the I.R.C. and Schedule 3 of the Malaysian Act.

[131] Schedule 3 paragraph 15 of the Malaysian Act provides for a straight-line method of depreciation. Under the I.R.C., capital expenditure is depreciated either under section 168 through the Accelerated Cost Recovery System for tangible property placed in service on or after January 1, 1981 or under section 167 for tangible and certain intangible property placed in service prior to 1981. The Accelerated Cost Recovery System authorizes accelerated methods of cost recovery over statutory periods that are unrelated to and shorter than the assets' estimated useful life.

[132] The rationale for this treatment of capital expenditure can probably be best understood as an accounting concept. Where an asset produce income over a period of time, expenses producing that asset should be written off over that same period. Where the income producing asset is not a "wasting" asset, then no such write off of the expenses to produce it is appropriate.

[133] (1925) 10 T.C. 155.

[134] *Ibid.*, at p. 188. See also Whiteman, "The Borderline Between Capital and Income", (1966) *Brit. Tax Rev.* 115.

Capital expenditure, therefore, is one which brings in a lasting asset or an advantage of enduring benefit. The expenditure in *British Insulated's* case concerned a lump sum of £30,000 contributed irrevocably by the taxpayer company to form the nucleus of a pension fund for the benefit of clerical and technical staff and which would endure throughout the life of the company. The expenditure so made was held to be of a capital ature because it created an asset of enduring benefit.

Another general statement was formulated by Lord Dunedin in *Vallambrosa Rubber Co. Ltd.* v. *Farmer,*[135] in which his Lordship established the criterion that "capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur 'every year'." However, it is submitted that not all expenditures spent once and for all are capital expenditures nor every recurring expenditure a revenue expenditure. This is because a capital consideration, say for a sale of land, is capital even if paid in installments spread over a number of years. Remuneration paid monthly is a revenue expenditure and that revenue character is not lost if the remuneration is paid in a lump sum.

Another general test formulated to determine whether an expenditure is a revenue or capital expenditure is to determine whether that expenditure forms part of fixed capital or circulating capital. Expenditure pertaining to fixed capital is expenditure invested in assets intended to be retained by the company more or less permanently and used in producing income. Circulating capital, on the other hand, is taken to mean assets turned over in the course of business (money, stock in trade) or what a trader parts with to make his profit. However, it is submitted that it is not always easy to demarcate the line between fixed capital and circulating capital. The reason is that the same kind of asset may be fixed capital in one business and circulating capital in another business. Land, for example, is fixed capital for an estate owner, but circulating capital for a housing developer.

Thus, the tests formulated above as to whether an expenditure is capital or revenue are general in character and may not lend predictability to making the distinction between capital and revenue expenditure.

The distinction between capital and revenue expenditure may be seen most vividly under the Malaysian position in the area of repairs and improvement expenses. It is provided in section 33(1)(c) of the Malaysian Act that repairs and maintenance expenses incurred on premises, plant, machinery or fixtures employed in business in the production of gross income are deductible. But repairs which amount to a rebuilding or reconstruction of premises, plant, machinery or works of a permanent nature are expressly disallowed under section 33(1)(c) of the Malaysian Act.

The line between a repair which involves a replacement of some part of the premises (which is a deductible revenue expenditure) and a replacement of the entirety of the premises (which is a non-allowable capital expense) is a narrow one. What distinguishes one from the other (which is

[135](1910) 5 T.C. 529.

often expressed as the difference between repairing and renewing premises) was best expounded in the case of *Lurcott* v. *Wakely & Wheeler,*[136] in which Buckley L.J. said,

> "'Repair' and 'renew' are not words expressive of a clear contrast. Repair always involves renewal; renewal of a part; of a subordinate part. . . Repair is restoration by renewal or replacement of subsidiary parts of a whole. Renewal, as distinguished from repair, is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole of the subject-matter under discussion."[137]

Therefore in such circumstances, the first problem is to ascertain what is the "entirety" of the premises in question, that is, is what has been replaced substantially a complete entirety in itself, or is it more properly regarded as only a part of larger premises. If the premises, so regarded, have been replaced, then the expenditure is capital; if, however, what has been replaced is only a part of larger premises and the replacement does not involve substantial improvements or extensions, then the expenditure can properly be regarded as a revenue expense.

What is substantially the whole and what is merely a subsidiary part is a question of degree and must be determined according to the facts in each case. Moreover, it all depends on what the court will treat as the "entirety" in any particular case. This may be illustrated by the decision in the Malaysian case of *Comptroller of Income Tax* v. *X Rubber Co. Ltd.*[138] The facts were that the taxpayer company owned a rubber estate which was low lying and required a special drainage system. This involved ten watergates each of which closed and opened automatically when the level of the water in the adjoining river rose or fell. One of the watergates sprang a leak and a new one had to be installed. The new gate functioned identically as the old gate. The High Court held that the construction of the new watergate was a repair of part of the drainage system. In the course of the judgment, the Court said,

> "It seems to me that what one has to consider is not the construction of the simple watergate as an independent entity but the relation it bears to the whole satisfactory working of all the gates, as 'one continuous unit of defence against flooding'. . . The 'premises' here, in my view, were the whole system of watergates constituting the drainage system as an entirety. This single watergate was merely a cog in that system. The replacement of the existing watergate by the building of a new one was simply a repair of the drainage system as an entirety. Therefore, the construction of this watergate was a repair of premises, such premises being the whole drainage system of the

[136] [1911] 1 K.B. 905.

[137] *Ibid.*, at p. 924.

[138] (1961) 27 M.L.J. 191.

ten watergates and the construction of the single watergate taken by itself, was not an independent entity which could be said to create any new asset."[139]

As a consequence, the Court regarded the cost of the construction of the watergate to be a revenue expenditure. Generally, repairs, or replacements to income producing property which do not materially add to its value nor appreciably prolong its life, but merely keep it in good and efficient operating condition, are allowable. On the other hand, improvements or additions to property will not qualify as deductions.

In the case of repairs to newly-acquired assets which were in a state of disrepair when acquired by the taxpayer, the expenditure on such repairs will be disallowed when the cost of putting them in repair is in reality a part of the capital cost of the acquisition. In *Law Shipping Company* v. *I.R.C.*,[140] a company bought a ship which was in disrepair. After purchasing the ship and before any repair work was undertaken, the ship embarked on a voyage. After its return from the voyage, the ship was repaired at a cost of $51,558. Of this sum, $39,558 was spent to remedy the state of disrepair in which the vessel was at the time of purchase while the balance related to deterioration during the voyage undertaken. The Revenue's claim that the cost of repairs attributable to the state of disrepair at the time of purchase was capital expenditure was upheld by the Court. *Law Shipping Company* v. *I.R.C.* may be distinguished from *Odeon Associated Theatres Ltd.* v. *Jones.*[141] In the latter case, the facts were that a company carried on the trade of proprietors of cinematograph film theatres. In order to expand during and immediately after the war of 1939-45, it purchased a number of theatres from other proprietors. The purchase price paid for any theatres was not affected by its state of disrepair. From the beginning of the war until the early 1950's, the building of theatres was prohibited as was decorating and repair work except for a small amount of essential maintenance. The type of work necessary to put the company's theatres into a proper state of repair was maintenance and repair work, which in normal times was carried out continuously.

Such repairs were carried out by the company in due course and were charged in their entirety to the profit and loss account. The Court held the repairs to be not capital expenditure because it was expenditure on maintenance which had for the first time become possible and worthwhile for the company to carry out. *Law Shipping's* case was distinguished by the Court as follows,

"There are a number of important differences between that case and this. One is that in that case the purchaser knew at the time of acquisition of the

[139] *Ibid.*, at p. 193.

[140] (1924) 12 T.C. 621.

[141] (1971) 48 T.C. 257.

> ship that after one further voyage a Lloyd's survey would be required and would involved very substantial expenditure if the ship were to continue to be used in the trade, whereas here what was in the purchaser's contemplation was that the theatre could be used profitably without making good the deferred repairs... A second difference is that in the *Law Shipping* case the Court drew the inference that if the Lloyd's survey had not been overdue, the seller would have exacted and the buyer would have paid a larger price, whereas here it has been found as a fact that the dilapidated state of the theatres did not materially affect the price. Another difference is that in the *Law Shipping* case, the repairs or replacements necessary to satisfy the Lloyd's survey were carried out after the first voyage of the ship whereas in the present case the repairs and replacements in question were carried out over a period beginning two years and ending ten years after the acquisition and there is no evidence to indicate that they cost any more than would have been incurred if the theatre had been acquired in good repair and subsequent dilapidations had been made good in the ordinary course of prudent maintenance."[142]

In the United States, the same principles as that applied under the Malaysian position in the area of repairs and improvement may be seen in the following cases. In *Mt. Morris Drive-In,*[143] the facts were that the taxpayer had acquired a piece of land for the purpose of building an outdoor movie theatre. As a result of the removal of vegetation from the land for the purpose of building the said theatre, the drainage of rain water onto a neighbouring land increased substantially. When threatened with a law suit by the neighbouring owner, the taxpayer installed a drainage system which carried the excess rain water to a public drain. In holding that the outlay on the drainage system was a capital expenditure, the majority of the Tax Court found that the need for a drainage system had been obvious and foreseable at the time the original construction work was undertaken. In addition, there was no "mere restoration or rearrangement" of the original capital asset, namely, the drive-in theatre, but that there was the acquisition and construction of a new capital asset, namely, the new drainage system. Accordingly, as the drainage system was a permanent improvement to the taxpayer's property, its cost constituted a capital expenditure.

It is to be noted that there were three divergent opinions expressed by the Tax Court in *Mt. Morris's* case. Each of these opinions may be seen as offering alternative ways as to how the tax system should approach the line between current and capital expenditure. The majority of the Tax Court viewed the drainage system as an integrated part of the drive-in theatre, without which the latter would have been incomplete and inadequate. Accordingly, the drainage system was regarded as part of the original mechanism, namely, the drive-in theatre, and not as an addition or replacement, which meant that the expenditure on the drainage system was to be

[142] *Ibid.*, at p. 287.

[143] (1955) 25 T.C. 272.

capitalized and depreciated with the theatre as a single unit. The concurring opinion, on the other hand, viewed the drainage system and the drive-in theatre as distinct capital assets which must be capitalized and depreciated separately. Accordingly, it did not matter whether the outlay on the drainage system was contemporaneous with the original construction of the theatre or took place at a subsequent time. The dissenting opinion treated the theatre as a capital asset but not the drainage system which was seen as not improving the useful live of the theatre. Accordingly, the expenditure on the drainage system was allowed as a current expense.

It would appear that the alternative offered by the concurring opinion represents the most accurate approach because the amount spent on each asset is allocated in accordance with their useful life. However, this approach would be appropriate only where the assets acquired can be regarded as distinct and independent items. Otherwise, the alternative offered by the majority opinion is to be preferred. This is because in such a case, the assets concerned are, in reality, part and parcel of one single unit. This is especially so if the asset or item acquired, having a usefull life extending over a taxable year, represents only a minor element of say, the machine. Accordingly, it should be capitalized and depreciated over the useful life of the machine. However, if the item in question represents not only a minor element of the machine but has a useful life of less than a taxable year then the alternative offered by the dissenting opinion is to be preferred. This is because the expediture incurred would almost certainly not result in prolonging the useful life of the machine so as to be regarded as an improvement[144] or alteration. Accordingly, the outlay should be regarded as a repair entitled to current deduction.

The principle that amounts paid or incurred for incidental repairs which do not add to the value or substantially prolong the useful life of the property and are thus not capital expenditures, may be illustrated in the following two cases. In *Illinois Merchants Trust Co., Executor,*[145] the facts were that a sudden lowering of the water level in the river left the upper ends of certain wood piles upon which the taxpayer's building rested exposed to the air, causing that part of the piles to decay from dry rot. As a consequence, the wall on the river side of the taxpayer's building settled to a point where it was likely that the entire building would collapse. In order to maintain the building in serviceable condition, it was necessary to saw off the rotted piles at a point below the new water level and to insert concrete supports between the ends of the submerged piles in the floor of the building, thus raising the river wall. The Board held that the taxpayer was entitled to deduct the cost of this work as a business expense for repairs. The Board was of the view that the expenditure did not prolong the useful

[144] Reg. 1.263(a)-1(b) of the I.R.C. provides that the most important indicia of an "improvement" are that the expenditure (i) materially adds to the value of the property and (ii) appreciably prolong its life.

[145] (1926) 4 B.T.A. 103.

life of the building beyond its probable normal life, even though it did extend the life of the building beyond what it would have been had the piles not been repaired. But the critical basis for permitting the taxpayer to deduct the expenditure currently was that there was a restoration of "damaged fabric" in order to keep the property in operating condition and that the work did not represent a complete replacement of any sizeable unit or a totally new construction. Similarly in *American Bemberg Corporation* v. *Commissioner,*[146] it was held that the expenditures incurred represented repairs and were deductible currently. The facts were that several large caveins occurred in the taxpayer's plant, caused by the condition of the soil and bedrock. In order to prevent having to abandon the plant, the taxpayer undertook certain drilling and grouting operations. In holding that the expenditures were for repairs, the Court took into consideration the physical nature of the work, the effect of the work undertaken, whether something new was created and whether the work afforded permanent relief or merely maintained the level of operation of the plant. The Court was of the view that the purpose of the work was to enable the taxpayer to continue the plant in operation on the same scale as before and was not to replace or rebuild the plant since neither the drilling nor the grouting was a work of construction nor did it create anything new and that only the intermediate consequence of the original geological defect had been dealt with. Accordingly, the expenditures were for repairs and were not capital expenditures.

Expenditures which are in reality for improvements, will be regarded as capital expenditures despite the fact that they are compelled by law or the Government. In *Jones* v. *Commissioner,*[147] the taxpayer had acquired a building of architectural and historical value to rent it out. Before the property was acquired by the taxpayer, it had been found by the State Fire Marshall to be unfit for habitation. Accordingly, architects recommended that the taxpayer demolish the building. When the local authorities refused to permit the structure to be demolished because of its architectural and historical value, the taxpayer restored and rehabilitated it so that the apartments therein could be rented out. The work consisted of filling cracks in the masonry and repointing all brick work, water proofing the exterior walls, replastering and repainting. The roof, plumbing equipment and electrical equipment were overhauled and, in part, replaced. The floors were levelled. Flooring and roof tiles were replaced. In holding that the entire cost of rehabilitating and restoring the building was a capital expenditure, the Court found that the work done amouted to a replacement or imporvement which prolonged the life of the building and increased its value as well as made it adaptable to a different use. Accordingly, no part of the sums expended, even though compelled by law, could be taken as a business expense for repairs.

[146](1948) 10 T.C. 361.

[147](1957) 242 F. 2d 616 (5th Cir.).

In addition to repairs and improvements, the following principles have also emerged from decided cases in the United States on the distinction between capital expenditure and current expense.

In *Woodward* v. *Commissioner*,[148] it was held that legal, appraisal and similar fees incurred in the acquisition of property are capital expenses, which can only be amortized if the underlying property is depreciable. In this case, the taxpayer incurred legal, accountants' and appraisers' fees of over $25,000 for services rendered in connection with the appraisal of the value of the stock of a minority shareholder, which the taxpayer subsequently acquired. The taxpayer sought to deduct these expenses on the ground that they were ordinary and necessary expenses paid for the management, conservation or maintenance of property held for the production of income, deductible under section 212 of the I.R.C. The Court disallowed the claim, holding that the fees represented capital expenditures incurred in connection with the acquisition of the capital stock of a corporation. As the stock was not depreciable property, the fees incurred could not be amortized but had to be added to the basis of the stock and recovered only upon the sale or disposition of the stock.

To the extent that expenditures, such as salaries and depreciation, are attributable to, for example, employee time or equipment used in construction or improvement of a capital facility, the amounts are not deductible in the current year but must be added to the cost basis of the facility. This principle was expounded in *Commissioner* v. *Idaho Power*.[149] The facts were that the taxpayer, a public utility, used various items of equipment (such as trucks, trailers and radio equipment) in constructing new capital facilities. The taxpayer contended that it could depreciate the cost of such items over their useful lives and take a current deduction for the depreciation allowance in each year. The Commissioner contended that the depreciation allowance for such items could not be deducted currently, but instead must be added to the cost basis of the capital assets which were constructed with the equipment. The Supreme Court upheld the Commissioner's contention, holding that the depreciation allowance on the construction equipment which the taxpayer used to build its own facilities had to be capitalized and added to the basis of the newly constructed facilities, which had a much longer useful life than the construction equipment.

On this principle, other construction-related expense items, such as tools, materials and wages paid to construction workers in connection with the construction or acquisition of a capital asset, are to be treated as part of the cost of acquisition of a capital asset and must be capitalized and amortized over the life of the capital asset so acquired.

In relation to insurance premium, it is now generally accepted that prepaid insurance premium for any substantial period of time must be

[148] (1970) 397 U.S. 572.

[149] (1974) 418 U.S. 1.

capitalized and prorated over the period to which they relate, whether the taxpayer uses a cash or an accrual method of accounting. In *Commissioner v. Boylston Market Association,*[150] the taxpayer in the course of its business, purchased from time to time fire and other insurance policies covering periods of three or more years. In holding that the prepaid premium must be capitalized and prorated over the relevant years, the Court was of the opinion that the insurance policy purchased was clearly a capital asset having a life longer than a taxable year and the premiums prepaid was protection for the entire period. Accordingly, the prepaid premium was a capital expense depreciable over the relevant years.

In the case of intangibles, such as a patent or copyright with a use or benefit extending substantially beyond the taxable year, an amount paid for their acquisition is generally a capital expenditure. If the taxpayer can establish (i) a cost basis in the intangible asset and (ii) a useful life for the asset which is finite and can be estimated with reasonable accuracy, the cost of the asset may be deducted over its useful life.[151] On the other hand, if the intangible asset has an indefinite useful life, such as goodwill, its cost may not be amortized.[152] In such a case, the cost will be recoverable only on sale or disposition of the property with which it was acquired.

From the foregoing discussion, it is clear that the rationale for disallowing a current deduction for capital expenditure is that such expenditure represents a present payment by the taxpayer for economic benefits that will accrue to him in the future. Thus, no initial loss is incurred by such expenditure which represents merely the conversion of one asset, usually money, into that of another which is of the same value as the price paid. Such capitalization would prevent the distortion of income that would otherwise occur if depreciation properly allocable to capital asset acquisition were deducted from gross income currently realized. Moreover, such a treatment accords with established accountancy principles.[153]

(iii) *Public Policy*[154]

Generally, the applicability of public policy limitations on business expense deductions has been given much more prominence by the courts in the United States than in Malaysia.

Briefly, under this doctrine, a taxpayer may not deduct otherwise allowable expenditures where to do so would constitute a contravention of a sharply defined public policy. In *Tank Truck Rentals, Inc.* v. *Commissioner,*[155] which is perhaps the best-known application of the

[150](1942) 131 F. 2d 966 (1st Cir.).

[151]Reg. 1.167(a)-(3).

[152]*Ibid.* See also *Commissioner* v. *Seaboard Finance Co.* (1966) 367 F. 2d 646 (9th Cir.).

[153]See footnote 132, *supra.*

[154]See, Note, "The Judicial Public Policy Doctrine in Tax Litigation", (1975) 74 *Mich. L. Rev.* 131.

[155](1958) 365 U.S. 30.

public policy doctrine to claims for business deductions in the United States, the Supreme Court disallowed a deduction for $40,000 in fines. The fines had been incurred by the taxpayer, an interstate motor carrier, for intentional violations of the Pennsylvania maximum weight laws for motor vehicles. The basis for the disallowance was a desire not to encourage "continued violations of state law by increasing the odds in favour of non-compliance. . . which would tend to destroy the effectiveness of the state's laws."[156] The taxpayer's argument that operating overweight trucks in Pennsylvania was necessary to conduct business was rejected, the Court holding that an expense cannot be "necessary" if the violates public policy.[157]

However, the public policy doctrine proved inconsistent and difficult to apply in specific contexts. Thus, in *Commissioner* v. *Sullivan*,[158] the Supreme Court refused to disallow the deduction of rent and wage expenses incurred by the taxpayer in operating an illegal bookmaking enterprise even though both the business itself and the specific rent and wage payments there in question were illegal under state law. The Supreme Court rejected the Commissioner's contention that the illegality of the enterprise required disallowance of the deduction, holding that to do so would be to tax this type of business on the basis of its gross receipts while all other business would be taxable on the basis of net income. The Court also indicated that if such a choice is to be made, Congress should do it. Again in *Lilly* v. *Commissioner*,[159] the Supreme Court upheld deductions claimed by opticians for amounts paid to doctors who prescribed the eyeglasses that the opticians sold. Similarly in *Commissioner* v. *Tellier*,[160] the Supreme Court held that legal expenses expended in an unsuccessful defense of a prosecution for fraud in the sale of securities could be deducted. The Supreme Court reitreated and emphasized its position that an otherwise allowable deduction should only be disallowed when in violation of a public policy that is sharply limited and carefully defined.

It was against this background that Congress in 1969 moved to codify the public policy ground for disallowing certain deductions by enacting, as part of the Tax Reform Acts of 1969 and 1971, various modifications, including, *inter alia*, section 162(c) and (f) to section 162 of the I.R.C. Thus, the statutory limitations on deductions for otherwise allowable expenses for bribes, kickbacks, fines and penalties were enacted in 1969 to codify the public policy restrictions on such deductions. In referring to these changes in section 162, the Senate Report stated that the new statutory coverage was intended to be all-inclusive and that public policy was not

[156] *Ibid.*, at p. 35.

[157] *Ibid.*, at p. 33.

[158] (1958) 356 U.S. 27.

[159] (1952) 343 U.S. 90.

[160] (1966) 383 U.S. 687.

sufficiently defined to justify the disallowance of deductions.[161] As a consequence, public policy *per se* may no longer be used to deny a deduction for a bribe, fine or similar penalty not within the specific ambit of section 162(c) or (f) of the I.R.C.[162] However, notwithstanding the Senate Report that public policy is not sufficiently defined to justify the disallowance of deductions, some courts in subsequent cases continue to apply public policy concepts in cases arising under section 162 of the I.R.C. Thus, in *Tucker* v. *Commissioner*,[163] the taxpayers were denied a deduction for a penalty imposed under New York State's Taylor Law. This provision authorizes a deduction of 2 days' pay for each day of an illegal strike by public employees. The Tax Court decided that the Taylor Law provision was a penalty under section 162(f) of the I.R.C. and observed that the sanction reflected a deeply and consistently held policy of the state with respect to the relationship between state and local governments and their employees. This policy, the Court indicated, would be frustrated by the allowance of a deduction.

However, it is to be noted that notwithstanding the 1969 amendments to section 162 of the I.R.C., the notions of public policy continue to apply to deny loss deductions under section 165 of the I.R.C This is so despite the dissenting opinion of Sterrett J. in *Mazzei* v. *Commissioner*[164] that, while the all-inclusive coverage of non-deductible expenses in the Senate Report was directed at section 162 of the I.R.C., the Report does seem to call for judicial restraint in other areas where Congress has not specifically limited deductions. Thus in *Mazzei's* case, it was held that a taxpayer who was hoodwinked into putting money into a box that was supposed to reproduce money, could not deduct his loss on the ground that there was a sharply defined national policy proscribing counterfeiting. In the Court's view, to allow the loss (which was directly related to the taxpayer's participation in the conspiracy to counterfeit currency) would be to frustrate this policy.

In relation to the deduction of illegal payments, the following are barred under section 162(c) of the I.R.C.: (i) illegal payments to government officials or employees (ii) other illegal payments (iii) kickbacks, rebates and bribes under medicare and medicaid.

As to the first category, no deduction is allowed under section 162(a) of the I.R.C. for any payment made directly or indirectly to an official or employee of any government, or any agency of any government if the payment constitutes an illegal bribe or kickback. If the payment is to a foreign official or employee of a foreign government, the question of whether the payment is regarded as illegal will be ascertained by reference

[161]Senate Report (1969) No. 91-552, 91st Congress, 1st Session 274.

[162]Reg. 1.162-1(a).

[163](1978) 69 T.C. 675.

[164](1974) 61 T.C. 497.

to the Federal Corrupt Practices Act of 1977. If the payment is illegal under the aforesaid Act, it will be so regarded and disallowed under section 162(c)(1) even if the payment is legal under the law of the foreign country.[165] The said Act makes illegal all direct or indirect payments, or offers to make payments by a United States citizen or his agent to officials of a foreign government, foreign political party or foreign political candidate to influence political action favourably towards the business of the party of the United States. The burden of proof for establishing whether a payment is illegal (or would be illegal by reference to the Federal Corrupt Practices Act of 1977 in the case of foreign payment) is upon the Service.[166]

As to the second category, illegal payments to parties other than domestic or foreign government officials or employees are also not deductible. The test of illegality here is whether the payment is illegal under any law of the United States or any law of a state, but only if the state law is generally enforced. The term "illegality" is stretched in that a payment which subjects the payor not only to a criminal penalty but also to the loss of a license or privilege to engage in a trade or business will be regarded as illegal for purposes of barring the deduction. Thus, only statutes that imposes some criminal or civil liability are within the scope of section 162(c)(2) of the I.R.C.[167] Illegal payments specifically include a kickback in consideration of the referral of a client, patient or customer. However, illegal payments prohibited under section 162(c)(2) do not cover price rebates which may be subtracted from gross sales in arriving at gross income.[168] The theory is that such a rebate is a subtraction from gross receipts in arriving at gross income and not a deduction.[169] Therefore, the transaction is not covered by section 162(c)(2) of the I.R.C. The burden of proof of establishing that the payment is illegal rests, as in the case of illegal payments to government officials with the Service.

Section 162(c)(3) of the I.R.C. disallows any deduction for rebates under Medicare and Medicaid, or under any state programme funded under the Social Security Act. Referral fees are specifically not deductible. There does not seem to be any requirement that the bribes or kickbacks be illegal under other state or federal laws, as long as they are made "in connection" with the provision of services or supplies under federally funded medical plans.[170]

[165] Regs. 1.162-18(a)(1)(iii) and 1.162-18(a)(3).

[166] Reg. 1.162-18(a)(5). See also Special Subcommittee of the Committee on Practice and Procedure, New York State Bar Association Tax Section, "Report on the Internal Revenue Service 'slush fund' Investigation", (1977) 32 *Tax L. Rev.* 161; Chu and McGraw, "The Deductibility of Questionable Foreign Payments", (1978) 87 *Yale L.J.* 1091.

[167] Reg. 1.162-18(a)(4).

[168] *Revenue Ruling* 82-149, 1982-83 I.R.B. 5.

[169] *Ibid.*

[170] Reg. 1.162-18(c).

Under section 162(f) of the I.R.C., no deduction is allowed for any fine or similar penalty paid to a government for the violation of law, even if such fine could be otherwise established to be an ordinary and necessary business expense. This codifies the *Tank Truck Rental* holding that payments for fines are not deductible whether or not the fines arise from intentional or inadvertent violations. The Senate Report makes it clear that not all penalties are nondeductible under section 162(f) of the I.R.C. Thus, fines or penalties that are imposed by local jurisdictions to ensure prompt compliance with filing requirements, and are in the nature of interest charges or late filing fees, are deductible.[171]

Compared to the United States, there have been no Malaysian court decision on a public policy limitation on business expense deductions. However, in practice, fines and penalties imposed in regard to late submission of returns or for failure to comply with the provisions of the Malaysian Income Tax Act and which amounts to an offence, have been denied deduction by the Director-General of Inland Revenue. In view of the absence of any Malaysian decision on public policy limitation, reference will be made to decided English cases.

An analysis of English decided cases on the subject of deduction of fines and penalties relating to violation of law, seems to indicate that the ground for disallowance is not so much one of public policy but rather that the fines or penalties were not connected with or did not arise out of the business. Such an observation may find support in the following two cases. In *Commissioners of Inland Revenue* v. *Warnes & Co., Ltd.*,[172] the Court dealt with a claim for deduction by a company in respect of a mitigated penalty imposed upon it under the Customs (War Powers) Act of 1915. In a brief judgment, Rowlatt J. disallowed the claim and threw considerable light on the subject of fines by observing thus:

> "But it seems to me that a penal liability of this kind cannot be regarded as an expense connected with or arising out of the trade. I think that an expense connected with or arising out of a trade must, at any rate, amount to something in the nature of an expense which is contemplable and in the nature of a commercial expense. I do not intend that to be an exhaustive definition but I do not think it is possible to say that when a fine, which is what the penalty in the present case amounted to, has been inflicted upon a trading body, it can be said that that is an expense connected with or arising out of the trade. . ."[173]

The above statement of law was given approval in the Court of Appeal case of *Commissioners of Inland Revenue* v. *Alexander Von Glehn & Co. Ltd.*,[174] which again involved a claim to deduct a comprimise penalty under

[171] Senate Report (1971) No. 92-437, 92d Congress, 1st Session 600.

[172] (1919) 12 T.C. 227.

[173] *Ibid.*, at p. 231.

[174] (1920) 12 T.C. 232.

the same wartime legislation directed against trading with the enemy. The Court held that the disbursement of the fine was not money wholly and exclusively laid out for the purpose of the trade. Lord Sterndale MR said;

> During the course of trading this company committed a breach of the law. As I say, it has been agreed that they did not intend to do anything wrong in the sense that they were willingly and knowingly sending these goods to an enemy destination; but they committed a breach of the law, and for that breach of the law they were fined. That, as it seems to me, was not an expense wholly and exclusively laid out for the purpose of the trade or connected with a business, but was a fine imposed upon the company personally so far as a company can be considered to be a person, for a breach of the law which it had committed. It is perhaps a little difficult to put the distinction into very exact language, but there seems to me a difference between a commercial expense in trading and a penalty imposed upon a person or a company for a breach of the law which they have committed in that trading. For that reason I think that both the decision of Rowlatt J. in this case, and his former decision in *IRC* v. *Warnes & Co.* which he followed, were right, and that this appeal should be dismissed with costs."[175]

A review of the above two cases shows that expenses which are permitted as deductions are such as are made for the purposes of carrying on the business, that is, to enable a person to carry on and earn profits in that business. It is not enough that the disbursements are made in the course of or arise out of or are connected with or made out of the profits of the business. They must also be for the purpose of earning the profits of the business. As was pointed out in *Von Glehn's* case, an expenditure is not deductible unless it is a commercial expense in trade and a penalty imposed for breach of the law during the course of trade cannot be described as such. Infraction of the law is not a formal incident of business and therefore, only such disbursements can be deducted as are really incidental to the business itself. They cannot be deducted if they fall on the taxpayer in some character other than that of a trader. Therefore, where a penalty is incurred for the contravention of any specific statutory provision, it cannot be said to be a commercial expense falling on the taxpayer as a trader, the test being that the expenses which are for the purpose of enabling a person to carry on a trade for making profits in the business are permitted but not if they are merely connected with the business.

The underlying thinking in the above cases is that a penalty for infraction of the law, however connected it may be with the taxpayer's trade or business, is not a disbursement incurred in the production of income or with the object of earning profits.

Accordingly, the United States and English courts seem to adopt different approaches in dealing with the question of the deductibility of penalties and fines imposed on a taxpayer for violation of law. It is submitted that the English courts' approach of denying a deduction on the ground that

[175] *Ibid.*, at p. 236.

such expenses are not disbursements incurred in the production of income or for the purposes of the trade, is more definite and precise in scope and is to be preferred as it would lead to consistency in application. A public policy approach, on the other hand, may be unsatisfactory in that in a case where the matter is not governed by statute or by clearly established principles, a consideration of what is public policy must necessarily involve balancing advantages against disadvantages. This would be a delicate balance in income tax law and may lead to inconsistent results and may also prove difficult to apply in specific context. This is borne out by United States cases decided before the 1969 amendments to section 162 of the I.R.C. and the United States Senate Report that public policy is not sufficiently defined to justify the disallowance of deduction in income tax law. Moreover, taxpayers are entitled to know, with a fair degree of certainty, the course they may take in conducting their business. The Tax Act defines the rights of the taxpayer and fixes the standard by which his rights are to be measured. Accordingly, deductions depend upon the legislative policy expressed in the fair and natural meaning of the legislature's words. In applying the public policy doctrine, the court is admittedly putting a gloss upon the deductions rule in the statute which specifies the criteria of deductibility.[176] Though the court should be allowed reasonable room for "interstitial judicial legislation",[177] it should resist temptations of policy-making lest it strays from the process of construction to a process of "interpolation" and "evisceration".[178] The better approach in this area would be for the Court to take the statute as it finds it, leaving to the legislature the job of specifying santions for the enforcement of statutes. As an English jurist[179] puts it, public policy is "a very unruly horse, and once you get astride it, you never know where it will carry you." Thus, it may carry the Treasury further than it wants to go and the ride may carry many taxpayers to a point of financial ruin on account of transactions involving at most mere technical guilt. Thus, unless the courts can come up with a more definite and precise test, it would be better to leave the legislature with the task of specifying the disallowance of particular expenses.

(iv) *Reasonableness*[180]

Section 162(a)(1) of the I.R.C. limits the deduction for salaries and other compensation for personal services to "reasonable" salaries and personal

[176]See Tyler, "Disallowance of Deductions on Public Policy Grounds", (1965) 20 *Tax L. Rev.* 665; Note, "Business Expense, Disallowances and Public Policy: Some Problems of Sanctioning with the I.R.C.", (1962) 72 *Yale L.J.* 108.

[177]B. Cardozo, *The Nature of the Judicial Process* (New Haven: Yale University Press, 1921) at p. 98.

[178]Frankfurter, "Some Reflections on the Reading of Statutes", (1947) 47 *Colum. L. Rev.* 527 at p. 533.

[179]Burrough, J. in *Richardson* v. *Mellish* (1824-34) All E.R. Reprint 258 at p. 266.

[180]See generally, Hoffman, "Heeding Significant Factors Improves The Odds For Reasonable Com-

services actually rendered. To the extent that they are unreasonable, it will not be allowed as a deduction. The limitation imposed under section 162(a)(1) of the I.R.C. is mainly to deny taxpayers the ability to avoid the double tax on corporate earnings or to artificially shift the liability for income within their families.

The reasonableness issue is usually to be found in cases where the compensation of an employee-shareholder is involved. Another situation in which the relationship between the parties is something more than merely an employer-employee relationship and thus gives rise to the reasonableness issue is where the employee is a child, parent or a friend of a controlling shareholder or sole proprietor. This is because corporate tax savings can be achieved if a closely-held corporation pays out its earnings in the form of salaries (which are deductible) to its stockholder-employee instead of paying them out in the form of dividends which are nondeductible.

The Regulations provide that reasonable compensation is the amount that would be ordinarily paid for like services by like enterprises under like circumstances.[181] Accordingly, the question of whether a salary paid is reasonable or not is to be determined by examining the facts in each case. The courts have developed a number of factors to be considered in determining what is reasonable compensation but no single factor is decisive. The major factors, as seen in the following cases, seem to be the level of compensation paid to other employees in comparable jobs,[182] whether the payments are pro rata to stockholdings, level of employer earnings and the type of work performed. In *Jones Brothers Bakery, Inc.* v. *U.S.*,[183] the issue was whether certain compensation paid by the plaintiff corporation to its president and general manager constituted reasonable compensation so as to amount to a deductible business expense under section 162(a)(1) of the I.R.C. In holding that they represented reasonable compensation for services rendered, the Court noted that the compensation paid was comparable to prevailing rates to holders of comparable positions by comparable companies within the same industries. Morever, the president and general manager's qualifications in relation to their jobs, the nature of the services performed by them and the responsibilities involved, all supported the conclusion that the compensation paid was reasonable. The Court also came to the conclusion that althought the president and general manager were major stockholders of the family-owned plaintiff corporation, the compensation paid did not constitute a distribution of profits by the corporation under the guise of compensation. On the other hand, in *Charles Schneider & Co.* v. *Commissioner*,[184]

pensation", (1979) 50 *J. Tax'n* 150; Ford & Page, "Reasonable Compensation: Continuous Controversy", (1979) 5 *J. Corp. Tax'n* 307.

[181] Reg. 1.162-7(b)(3).

[182] *Ibid.*

[183] (1969) 411 F. 2d 1282.

[184] (1974); 500 F. 2d 1481 (8th Cir.).

the Court held as unreasonable certain portion of compensation paid by the plaintiff corporation to its president. The president at all times owned all of the corporate stock and did not maintain an active role in the company's affairs. In disallowing, as a business expense, certain portion of the compensation paid, the Court was of the view that the nature, extent and scope of the work performed by the president did not justify the salary paid. This was because the president was devoting his principle attention to another company. Accordingly, the part-time nature of his work in the plaintiff's corporation did not justify the compensation said. Moreover, the compensation paid the president was grossly disproportionate to those paid to executives in companies of similar size in the industry. Furthermore, the fact that no dividend was ever paid by the plaintiff corporation even though it enjoyed consistent profits and immense success in its business, coupled with the fact that the president owned all of the stock of the corporation, also gave rise to an inference that some of the compensation paid really represented a distribution of profits. Similarly in *Charles McCandless Tile Service* v. *U.S.*,[185] the Court disallowed, as a business expense, compensation payments to two principal officer-stockholders of the closely-held plaintiff corporation. The officers concerned each owned half of the stock of the corporation. The corporation had neither declared nor paid dividends to its shareholders in any amount since its formation five years earlier and during each of the years in controversy, approximately 50% of net profits (before salaries and federal income tax) was paid to the two principal officer-stockholders as compensation. As the compensation was in fact in proportion to the stockholdings of the principal stockholders, the Court held that it necessarily contained a distribution of corporate earnings and, as a return on equity capital equal to 15% of net profits (before salaries and federal income tax) would have been reasonable and justified in the years under review, that proportion of the compensation payments were actually distributions of corporate earnings and accordingly not deductible under section 162(a)(1) of the I.R.C

It should be noted that the reasonableness issue raised in the above cases involved the compensation of an employee-shareholder. However, the principle of reasonable compensation has also been applied to situations where the employee-shareholder relationship was absent. Thus in *Patton* v. *Commissioner*,[186] the Court held as unreasonable a portion of the compensation paid by a partnership to an employee for his services as a book-keeper. A majority of the Court of Appeal held that employees of similar training and doing similar jobs were not paid as much as the book-keeper in the instant case. Moreover, the nature of the services performed by the book-keeper and the responsibilities his job entailed, did not justify the salary paid. The Court also pointed out that the arrangement between the

[185](1970) 422 F. 2d 1336.

[186](1948) 168 F. 2d 38 (6th Cir.).

parties in which they regarded the compensation paid as reasonable was not binding on the Commissioner. The dissenting opinion, on the other hand, argued that so long as the compensation paid was the result of a *bona fide* arrangement and there was no evidence to show that it was intended to by anything other than a salary, the amount paid should be allowed in full notwithstanding that it was on the high side.

Although the majority of the Court of Appeal may have been put on suspicion that the arrangement may have been entered into to reduce the partnership's net income and hence the taxable income of the two partners by withdrawing the funds in the form of salary, the dissenting opinion is nevertheless to be preferred. Otherwise, it would be opened to the Commissioner to attack salary paid in pursuant of a *bona fide* arrangement even though there is no evidence to suggest that it was entered into for tax savings purposes. Moreover, the majority's approach resulted in double taxation of the salary in question. First of all, the book-keeper will be taxed on the compensation received, whether reasonable or not. Second, the amount of the salary disallowed as unreasonable will increase the partner's taxable income which will be subject to tax. Accordingly, it is submitted that where a *bona fide* arrangement has been entered into to pay salary to an employee, which may nevertheless be on the high side and in which the parties are unrelated, the amount of the salary paid should not be disallowed as unreasonable in the absence of any evidence of a tax savings motive.

In regard to the Malaysian position, there is nothing in the Malaysian Act which provides for the quantifying of deductible expenses. The basis on which an expense may be disallowed is that it is not actually incurred in the production of income. Thus in both *Copeman* v. *Williams Flood & Sons Ltd.*[187] and *Stott & Ingham* v. *Trehearne,*[188] excessive revenue expenditure was examined to see whether it was incurred in the production of income. In the former case, excessive remuneration had been paid to directors of a company. The directors in question were a son and daughter employed in the family company, who had each received fees of $2,600 for minimal duties as a telephonist and buyer respectively. The Court held that only that proportion, if any, of those remuneration genuinely expended wholly and exclusively for the purpose of the company's trade would be allowed. In the course of the judgment, the Court said,

> "It may well be that there are sums which are paid to the directors as remuneration for their services in accordance with the articles of association and in accordance with a resolution of the company, but it does not necessarily follow in the least that they are sums which are wholly and exclusively laid out for the purposes of trade."[189]

[187](1940) 24 T.C. 53.

[188](1923) 9 T.C. 53.

[189]*Op. cit.*, at p. 56.

In the latter case, a firm, which consisted of a father and two sons, who were entitled to profits in equal shares, claimed that the whole of the remuneration paid to the sons by way of salary and commission should be allowed as a deduction in computing the business profits for tax purposes. The sons, in addition to their salary, had been paid a commission on the profits at a rate of 10%. This commission was subsequently increased to 33⅓% without a corresponding increase in their duties as managers and in their responsibility of running the affairs of the business. Emphasizing the nature and extent of the work performed by the sons, the Court held that only up to 10% of the commission, instead of the full 33⅓% could be regarded as paid to the sons for services rendered as managers of the business, and as deductible in arriving at the profits of the business for income tax purposes.

Thus, in the light of these two cases, excessive revenue expenditure may be restricted if a portion does not relate to the production of income. However, it is submitted that if the expenditure incurred constitutes a genuine expenditure relating to the production of income and is neither colourable or fraudulent and is not undertaken to avoid tax, then it is not opened to the Revenue to set the quantum of the expenditure that should be incurred. Thus, it is not opened to the Revenue, for example, to substitute a different price for the price which the taxpayer paid to acquire trading stock where it had not been shown that the price paid for the trading stock by the taxpayer exceeded that which would have been payable on the open market. To allow the Revenue to do otherwise, would be to revise every such arm's-length transaction which are straightforward and honest bargains between the parties and to defeat what they had agreed on.

(v) *Sham Or Uneconomic Transactions*

Both the Malaysian and the United States courts have evolved significant doctrines for disallowing deductions and other tax benefits on transactions that appear to satisfy all the statutory criteria for a deduction. These various doctrines, known as sham transaction, substance over form and business purpose, enable the courts to strike at carefully structured transactions where it appears that the taxpayer is obtaining a tax benefit not contemplated for by the particular provision involved.[190]

Where the taxpayer had merely entered into a transaction to take advantage of provisions intended to be available to him under the Tax Act, the validity of the transaction is not affected by these doctrines merely because the tax consequences which it attracts are advantageous to the taxpayer. However, it would be different if the transaction is varied in an attempt to produce a deduction which otherwise would not have arisen. Thus, the fact that a taxpayer chooses to use a corporation to conduct his business cannot be attacked as a sham *per se* merely because the use of a corpora-

[190] See Bittker & Menikoff, "Restructuring Business Transactions For Federal Income Tax Purposes". (1978) *Wis. L. Rev.* 715.

tion will in fact reduce the taxpayer's overall tax liability by splitting income between the corporation and the taxpayer. Provided the steps used in the transaction are the steps normally used to obtain the concession provided by the specific provisions of the Tax Act or the steps are in line with the policy objectives of the provision, these steps do not invite the application of these doctrines.

The application of these various doctrines may be seen in the following Malaysian and United States cases so as to give a feel for the kind of transactions that are likely to trigger their application.

In the United States case of *Knetsch* v. *U.S.*,[191] the taxpayer purchased deferred annuity savings bonds for four million dollars paying 2.5% interest and financed almost entirely by non-recourse indebtedness secured by the annuity bonds themselves. The interest on the non-recourse indebtedness was 3.5%. Thus, the transaction was economically a disaster. However, by prepaying the interest on the non-recourse loan (and assuming that the increase in the value of the bonds would be taxed at capital gains rates), and by deducting the interest from income that would otherwise be taxed at a high marginal rate, the taxpayer actually profited on the entire transaction. The Supreme Court labelled the transaction a sham and held that no valid indebtedness existed. Without a valid and binding indebtedness, interest paid by the taxpayer was not deductible. In the course of the judgment, the Supreme Court said,

> "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. . . But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."[192]

The Supreme Court, thus, decided that in order for the taxpayer to deduct interest paid pursuant to the terms of a transaction, the transaction must have some substance, that is, some purpose, other than the tax deduction produced by the transaction.

In *Goldstein* v. *Commissioner*,[193] another United States case, the business purpose doctrine was invoked to disallow the taxpayer's deduction of interest she prepaid on the loans. In this case, the taxpayer won $140,000 in the Irish Sweepstakes and, on the advice of her son, purchased one million dollars of United States Treasury Notes paying interest of 1.5%, borrowing one million dollars from two different brokerage houses at 4% to finance the transaction. The notes were pledged as collateral for the borrowing. The Court denied the interest deduction on the ground that the transaction had no substance or purpose aside from the taxpayer's desire

[191](1960) 364 U.S. 361.

[192]*Ibid.*, at p. 365.

[193](1966) 364 F. 2d 734 (2d Cir.).

to obtain the tax benefit of a large interest deduction to offset the Sweepstakes winnings. In the course of the judgment, the Court said,

> "In other words, the interest deduction should be permitted whenever it can be said that the taxpayer's desire to secure an interest deduction is only one of mixed motives that prompts the taxpayer to borrow funds; or, put a third way, the deduction is proper if there is some substance to the loan arrangement beyond the taxpayer's desire to secure the deduction."[194]

It is to be noted that the Court in *Goldstein's* case did not characterize the transaction as a "sham" as money actually changed hands between independent companies, the taxpayer and the government. Also the instruments actually were purchased and sold. In *Knetsch's* case, however, every transaction took place between the taxpayer and the one insurance company and in fact, what was stated to have happened on paper never really happened at all, making the transaction really a "sham".

The Malaysian position with regard to sham transactions may be seen in the following two cases.

In *Comptroller of Income Tax* v. *A.B. Estates Ltd.*,[195] the facts were that in late 1961, the taxpayer company acquired the entire shareholding of X Ltd., a derelict tin mining company, which had accumulated tax losses of $124,424 and available to it for carrying forward to be set-off against future trading income. Subsequently, in December 1961, the taxpayer company purchased a rubber estate, the average net profit from which was admittedly $16,000 per annum. In January, 1962, the taxpayer company leased the rubber estate to X Ltd., its subsidiary, for a period of 5 years at an annual rental of $1,200.

The advantage from a tax point of view to the companies was that out of an overral income of $16,000 only $1,200 (less expenses, if any) would be taxable in the hands of the taxpayer company, whilst the balance of $14,800 would be set-off against the accumulated tax losses of X Ltd. This advantage would be available so long as the tax losses remained unabsorbed.

On these facts, the Federal Court found that the amount of the income foregone under the lease was to be held by the subsidiary company for the sole use and benefit of the taxpayers' themselves. Thus, the lease transaction was not one motivated by any economic consideration other than to obtain a tax advantage. Moreover, the taxpayer company had given much thought and time to planning the scheme. Accordingly, the lease transaction was held to be one not in the ordinary course of business and was a sham transaction which could be disregarded by the Revenue.

A similar result was obtained in *C.E.C.* v. *Comptroller of Income Tax*.[196] In this case, the taxpayer, aged 70, was the head of a large family

[194] *Ibid.*, at p. 741.

[195] [1967] 1 M.L.J. 89.

[196] [1971] 2 M.L.J. 43.

of twenty-nine. He was the Chairman of the Board of Directors of a large private family company dealing in buying and selling land for development. He purchased two pieces of land from his own personal funds and obtained government approval to develop these lands. These lands, however, were registered in the names of his two sons who were residents of Hong Kong. All the negotiation for the purchase of the said lands and the subsequent application for planning approval were dealt with by the taxpayer himself.

The plans to develop these lands were subsequently abandoned and both the sons then sold the two pieces of land to the family company at considerable profits. At all material times, the taxpayer was the Chairman of the Board of Directors of the family company. Although the two sons were also directors of the construction company, they never attended any meetings of the Board though they were shown in the minutes of the meetings as having been present. On these facts, the Court held that the two pieces of land in question were not in fact owned by the two sons and that the taxpayer remained the owner of these properties. The Court was of the view that the arrangement between the taxpayer and his two sons as regards the said lands was an artificial arrangement or a sham device undertaken to avoid tax on the part of the taxpayer. Accordingly, the gains or profits from the sale of these properties to the family company were held to be received by the taxpayer from his business of dealing in land and for which he was liable to tax.

In the light of the foreging cases, it is clear that unless a transaction entered into can be proved to be motivated by some economic or purposive consideration other than the desire to obtain a tax deduction produced by the transaction, it will be struck down by the courts as being artificial or a sham. In such a case, the transaction will be disregarded and if necessary, adjustments will be made to reflect the true position.

Conclusion

From the foregoing discussion, it is clear that although a net income tax should allow deductions for all costs of earning income, this principle is hard to apply in the areas of commuting, travel and entertainment and child-care expenses because of the difficulty of distinguishing between costs of earning income and personal consumption. However, any proposed deduction for commuting expenses would be undesirable because of the administrative difficulties involved and because such expenditures represent, in large measure, personal preferences in regard to living arrangements. With respect to travel and entertainment expenses, stricter standards are required because the present rules and procedures covering such expenses do not seem to be effective in limiting deductions to necessary costs of earning income. In regard to house-keeping and child-care expenses, although they seem to be predominantly personal consumption, nevertheless a credit given in respect of such expenses seems justified in view of the existence of costs that cannot be accurately measured.

As for capital expenditure, the tax law requires that the expenditure be capitalized rather than be deducted as a current expense, since such ex-

penditure represents a present payment by the taxpayer for economic benefits that will accrue to him in the future. Such a treatment would prevent the distortion of income that would otherwise occur if depreciation properly allocable to capital asset acquisition were deducted from gross income currently realized.

In regard to legal fees incurred with respect to the ascertainment of the profits of the taxpayer's business, the better approach under the Malaysian law would be to provide for a deduction in view of the fact that such costs are a consequential expense incurred in the course of carrying on a business. However, to qualify for a deduction, such legal expenses must be incurred solely for the purpose of ascertaining the profits of the taxpayer's business and not for tax matters unconnected with his business or trade.

With respect to the disallowance of expenses incurred in the carrying on of a business on grounds of public policy, it would seem that the better approach would be to enact an express provision to provide for their disallowance. This would provide taxpayers with an element of certainty in conducting their trade or businesses. A public policy approach, on the other hand, will result in the application of an ambiguous and vague standard as its scope is never sufficiently defined and accordingly, such an approach will lead to inconsistency in application. Thus, in the absence of a more definite and precise judicial test, it would be better to leave the legislature with the task of specifying the disallowance of particular expenses.

Teo Keang Sood*

*Lecturer, Faculty of Law,
University of Malaya