

Business Income from Services – When Should It be Taxed?

A recent landmark court ruling could have wide implications for companies and businesses with income generated from services. *By Vivian New*

Businesses in the service industry pay tax on income derived from the provision of services. Nothing contentious about that.

However, the timing of taxability for service income tends to generate more questions. Section 24 of the Malaysian Income Tax Act (Section 24) lays down the rules

for determining when business income should be taxed, whether it is in respect of goods sold, services rendered or the use of property.

Section 24 provides that “*Where in the relevant period a debt owing.....arises in respect of any services rendered at any time in the course of carrying on a business, the amount of the debt shall be treated*

as gross income....for the relevant period”.

This Section has been widely interpreted to mean that business income arising from the provision of services should be taxed in the year the debt owing to the service provider in respect of the services arises, regardless whether the services have been rendered or will



be rendered in the future.

As Section 24 states, the debt is "in respect of any services rendered at any time". A debt is generally regarded as owing when the sum is not refundable and therefore, the service provider has an unconditional right to that sum.

However, the interpretation of Section 24 has been subject to much debate over the years and issues surrounding the timing of taxability of business income have also been brought to Malaysian courts for determination.

CONTRACTUAL LICENSE

One of the key issues which have been challenged involved the taxability of advance service fees. The Inland Revenue Board (IRB) seems to view that such fees should be taxable in the year of receipt in certain cases, especially when the possibility of a refund is remote.

However, taxpayers heaved a sigh of relief when the Court of Appeal delivered a landmark decision in the recent case of *Ketua Pengarah Hasil Dalam Negeri v Clear Water Sanctuary Golf Management Bhd (2015)*¹ (the Clear Water case).

In the Clear Water case, the Taxpayer was an operator of a golf and recreational club. Club memberships were available through the grant of a contractual license under a License Agreement (Agreement).

Under the Agreement, members were required to make Advance Payments equivalent to the total Annual License Fee payable for the term of the license. The Annual License Fee was payable for the services rendered by the Taxpayer to the members each year, but collected upfront as a security.

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The Court of Appeal held that the beneficial ownership of the Advance Payments remained with the members during the license period. Members were able to request for a refund upon cancellation of membership.

Interestingly, the Judges also took the view that services are required to be rendered for there to be a debt owing in respect of the services rendered and Section 24 does not refer to future services. In other words, business income is only taxable when services have been rendered.

The decision made by the Court of Appeal for the Clear Water case was, however, short-lived when the Government subsequently proposed an amendment to Section 24 in the Finance Bill 2015 which was issued

on 23 October 2015.

Based on the proposed amendment, business income received for services to be rendered will be taxable in the year the sum is received, notwithstanding that no debt is owing to the service provider in respect of such services.

Where the income which has been taxed is subsequently refunded to the customer, a deduction may be claimed in the year the amount is refunded. Effectively, when businesses receive income from services in advance, the income must be taxed although services have not been rendered and that such sum may be refundable.

The proposed amendment will take effect from 2016 onwards, after the Finance Bill is enacted as law (usually within several months after



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the issuance of the Bill). Hence, the Court of Appeal's position taken in the Clear Water case will be nullified soon.

With the proposed amendment to Section 24, it has wide-ranging implications to many industries, especially those where the collection of advance payments is a norm. Golf and recreational clubs are a good example.

TIMING OF TAXABILITY

Just like Clear Water Sanctuary Golf

Management Bhd, most golf and recreational clubs collect license fees in advance in return for the provision of services to members over the term of the license, typically 30 to 60 years.

For many years, most clubs assess license fees to tax over the period of the license. From 2016 onwards, they can no longer do that. License fees received in advance would need to be taxed in the year of receipt, regardless of the term of the license.

The possibility of a refund upon closure of the club or cancellation of membership would no longer be relevant in determining the timing of taxability.

Retail businesses which sell packaged services such as gymnasiums and beauty centres

would also be impacted. Packaged fees are often collected upfront by these businesses in consideration for services to be rendered over a period of time. These fees would be taxed in the year of receipt notwithstanding that services will be rendered at a later stage and that a portion of the fees may be refundable.

The new Section 24, when enacted as law, would negate long established tax principles which many have subscribed to over the years.

Questions still arise as to whether it is equitable to tax refundable sums collected for future services as such sums are strictly not income to the service provider until the service provider is fully entitled to them.

As we get accustomed to this new set of rules, taxpayers in certain industries may need to re-evaluate their cash flow strategies as they expect an increase in corporate tax payable in 2016. ¹

¹ No written judgement was made by the Court of Appeal. The written judgement made by the High Court is cited as *Clear Water Sanctuary Golf Management Bhd v Ketua Pengarah Hasil Dalam Negeri* (2014) MSTC 30-075.

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