

IN THE JUDICIAL COMMITTEE OF THE
PRIVY COUNCIL

O N A P P E A L

FROM THE FEDERAL COURT OF MALAYSIA

B E T W E E N :

LAHAD DATU TIMBER
SENDIRIAN BERHAD

Appellant

- and -

10 THE DIRECTOR-GENERAL OF
INLAND REVENUE

Respondent

CASE FOR THE APPELLANT

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1. This is an appeal from the judgment of the Federal Court of Malaysia (Lee Hun Hoe, C.J. Borneo, Ong F.J. and Ho J.) dated the 29th December, 1977, allowing an appeal by the Respondent from the judgment of the High Court of Borneo (Yusoff, J.) dated the 30th June, 1976 allowing an appeal by the Appellant from an Order of the Special Commissioners of Income Tax dated the 11th day of July, 1974, which had dismissed the Appellant's appeal against a notice of additional assessment dated the 9th December, 1973, in respect of the Year of Assessment 1969.

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2. The appeal arises out of transactions between the Appellant company, Lahad Datu Timber Sendirian Berhad, which is referred to in this case as "LDT", and the Ulu-Tungku Co-operative Land Development Society Limited of Lahad Datu ("the Society"). Two disputed issues arise:

30 (a) whether certain profits earned by LDT, which are admittedly liable to income tax, are liable to timber profits tax as well;

(b) whether the amount of those profits as shown in LDT's profit and loss account should

be increased for tax purposes by the addition to them of payments of three kinds made by LDT.

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3. In a little more detail the issue at 2(a) above arises in this way. LDT's tax liability for the year of assessment 1969 is derived from the profits of its accounting period to 31st December 1968. The profit and loss account for that period contains an entry for income described as "agency fee" of \$303, 313. 66. The Inland Revenue contended that the income so described was "income derived from timber operations", that is to say income from "the extraction of timber from a forest in Malaysia. . . ." within s. 19 of the Supplementary Income Tax Act 1967, so as to be liable to timber profits tax under s. 20 of the same Act. LDT contends that the income is not "income derived from the extraction of timber", on two alternative grounds. Either the income was remuneration for a service rendered to the Society by LDT, namely the service of selling the Society's timber for it; or the income represented profits from buying and selling timber which had already been felled and extracted from the forest. 10 20

4. As regards issue (b) in 2. above, an agreement between LDT and the Society (of which more details are indicated later in this Case) provided for LDT to make certain payments to or for the benefit of the Society. The amount described in LDT's accounts as "agency fees" was a balance left in the hands of LDT after making or providing for those payments. However, s. 39(1)(g) of the Income Tax Act 1967 reads as follows:- 30

"...In ascertaining the adjusted income of any person from any source for the basis period for a year of assessment no deduction from the gross income from that source for that period shall be allowed in respect of -

(g) any sum, by whatever name called, payable (otherwise than to a State Government) for the use of a licence or permit to extract timber from a forest in Malaysia." 40

The Inland Revenue contend that the payments made by LDT to or for the benefit of the Society were

payments for the use of a licence or permit to extract timber from the forest and therefore should be added back to the assessable profits of LDT for income tax and timber profits tax. LDT denies that this is so, for one or other of the following alternative reasons:

10 (i) Either the payments were merely instances of an agent accounting to a principal for the principal's money and are not affected by any question of deductibility, either under s. 39(1)(g) or otherwise; or

(ii) The payments were the price paid by LDT for felled and extracted timber which LDT sold to customers in the course of its trade. In this case it is necessary for the payments to be deductible, but there is no question of their being disallowed under s. 39 (1)(g), since they are paid to buy timber, not for the use of a licence or permit to extract timber.

20 5. The detailed facts appear in the Case Stated and the supporting documents. This paragraph contains a summary of what it is submitted are the salient facts. A preliminary observation of general application is that the commercial exploitation of timber growing in a forest involves two stages. The first stage is that the timber must be felled and extracted from the forest. The second stage is that the felled timber must be sold. It is usual for timber which has been felled to be delivered to a log pond and stored there until it is sold. Accordingly, delivery to the log pond typically
30 terminates the extraction stage of the entire series of operations and precedes the selling stage.

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In LDT's submission, the salient facts of the case are as follows :

(a) The Society owned an area of timber-bearing land and entered into agreements with LDT for the commercial exploitation of the timber.

40 (b) The precise nature of the original agreement between the Society and LDT (or LDT's predecessors) is obscure, but in LDT's submission is irrelevant to this appeal, since throughout the accounting period to 31st December 1968 the position was governed by two agreements, both made on 13th June 1967 and both made between LDT and the Society, the full text of which were before the Commissioners and are available

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to Your Lordships. One agreement is headed "Agreement for Timber Extraction" and the other is headed "Agreement for Timber Export and Execution of Certain Works". In this case they are referred to respectively as "the Extraction Agreement" and the "Export and Works Agreement".

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(c) The Extraction Agreement provides for LDT to sell the Society's timber and to deliver it to the log pond. LDT is to be paid for its services at the rate of \$1 per cubic foot. In the period in question the amount which LDT earned under this agreement was \$686,775.70. LDT has at all times accepted that the "Extraction charges" so received were income liable to timber profits tax.

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(d) Clause 1 of the Export and Works Agreement provides for LDT to sell on behalf of the Society the timber extracted from the forest. Clause 3 provides, inter alia, that LDT shall make sales "either in the name of the Society or in the name of the contractor" (i. e. LDT). Other clauses contain financial provisions. At the hearing before Your Lordships LDT will refer in detail to the full terms of the agreement. At this point Your Lordships' attention is respectfully drawn to clauses 5 and 9(1) and (2). Clause 5 obliges LDT to execute and pay for certain construction works in the Lahad Datu area. Clause 9(1) obliges LDT to pay an amount required for the planting, maintenance and fencing of an area of land which (presumably) belonged to the Society. Clause 9(2) obliged LDT to make payments to the Society at fixed rates per cubic foot in respect of logs sold and exported. The payments under these three provisions of the Export & Works Agreement (i. e. clauses 5, 9(1) and 9(2)) are the payments which, it is contended by the Inland Revenue, have to be added back for tax purposes by virtue of s. 39(1)(g) of the Income Tax Act 1967.

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(e) Both agreements contain similar provisions for their termination. Each may be terminated by either party upon a

breach, and each may be determined by LDT on one month's notice. Similarly each agreement runs for a period of 4 years, subject to a proviso for possible extension if there is delay which could not reasonably have been avoided by LDT. Nevertheless, neither agreement refers to the other, and LDT submits that neither is in law dependent on the other. Either agreement could be terminated (by mutual consent or otherwise) without affecting the continued operation of the other.

(f) Shortly afterwards LDT entered into an agreement with a firm called Yong Brothers of Lahad Datu whereby it sub-contracted its obligations under both the Extraction Agreement and the Export & Works Agreement to Yong Brothers.

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(g) The development of the forest then proceeded. As and when timber was sold and exported from the log pond Yong Brothers, who received the price in the first instance, deducted their charges and commissions and paid over the balance to LDT. The way in which the receipts fell to be dealt with by LDT is best shown from the accounts and accompanying statement, as explained in (h) below.

(h) The profit and loss account of LDT for the year to 31st December 1968 describes the amount of \$303,313.66. as "agency fee - per attached statement". The statement was in the form set out below. The notes were not part of the original statement, but have been added in the preparation of this Case.

STATEMENT SHOWING AGENCY FEE CALCULATION AT
31.12.1968

		<u>Note</u>
Proceeds from Timber Sales	686,775.7 cu. ft.	
	1,789,645.59	(1)
<u>Less</u> Royalty	³⁰⁰ 399 ,380.69	(2)
Fixed Commission due to Ulu Tungku Co-op Society	140,175.54	(3)

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			<u>Note</u>
Extraction fee at \$1.00 per cu. ft.	686,775.70		(4)
Planting Payments	201,000.00		(5)
Development Cost	<u>158,000.00</u>	<u>1,486,331.93</u>	(6)
Agency Fee transferred to General Profit & Loss A/c..		<u>\$ 303,313.66</u>	10

Notes

- (1) This was the amount received from Yong Brothers, net of their charges and commissions.
- (2) This was paid to the State Government by LDT, as provided by clause 2(3) of the Export & Works Agreement. Whether LDT made payment on behalf of the Society or on its own behalf, there is no dispute that the amount of the royalty falls to be excluded from LDT's taxable income.
- (3) This is the amount payable under clause 9(2) of the Export & Works Agreement, i. e. an amount calculated at fixed rates per cubic foot in respect of logs sold. 20
- (4) This is the fee earned by LDT under the Extraction Agreement. It is income of LDT and liable both to income tax and timber profits tax, but it operates to reduce the amount earned by LDT under the Export & Works Agreement as opposed to the Extraction Agreement.
- (5) This is the amount attributable to the accounting period and payable by LDT under Clause 9(1) of the Export & Works Agreement. 30
- (6) This is the amount attributable to the accounting period and payable by LDT under clause 5 of the Export & Works Agreement.
6. As already indicated, the Inland Revenue assessed LDT to tax for the year of assessment 1969 (based on the accounts to 31st December 1968) on the footing that the "agency fee" was liable to timber profits tax and that the three amounts, described in the statement set out above as "fixed commission", etc., 40

"planting payments" and "development cost" should be added back by virtue of s. 39(1)(g) in the computation of LDT's taxable income. LDT appealed to the Special Commissioners, who accepted the Inland Revenue's contentions on both points. LDT appealed by way of Case Stated to the High Court of Borneo. In that court Yusoff J. allowed LDT's appeal save as respects the amount of \$140,175.54. described in the Statement as "fixed commission" to the Society. The Inland Revenue appealed to the Federal Court of Malaysia (Lee Hun Hoe C.J. Borneo, Ong F.J. and Ho.J.), which allowed the appeal, substantially on the grounds that the matters in dispute were in essence questions of fact to be determined by the Special Commissioners, and that the courts on appeal ought not to interfere with the conclusions of the Commissioners. Pursuant to leave granted by the Federal Court on 10th July 1978, LDT now appeals to the Judicial Committee of the Privy Council.

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7. The principal submissions which LDT will seek to develop before Your Lordships are as follows:-

(a) The questions to be determined in this appeal are not questions of fact, but are questions of law. They depend on the true legal analysis of the relationship between LDT and the Society created by the Extraction Agreement and the Export & Works Agreement. They also depend on the proper manner of applying to that relationship the relevant statutory provisions, which are s. 39(1)(g) of the Income Tax Act 1967 and the definitions in s. 19 of the Supplementary Income Tax Act 1967 of "Income derived from timber operations" and "timber operations".

(b) Although the Extraction Agreement and the Export & Works Agreement were obviously negotiated at the same time as each other, each deals with a distinct subject-matter, and the separation into the two agreements of the entire arrangements concluded between LDT and the Society is natural and in no way artificial. Each agreement takes effect exactly according to its terms, and the Inland Revenue cannot successfully contend that the true legal

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relationship between LDT and the Society is to be found anywhere other than in the provisions of the two agreements.

(c) Timber held in the log pond and not yet sold to a customer belongs to the Society and does not belong to LDT. At that stage the timber has been dealt with only under the Extraction Agreement, and the Export & Works Agreement has not yet applied in relation to it. The point is clearly brought out by considering the status of any timber held in the log pond when the Export & Works Agreement terminates. LDT submits that such timber will indubitably belong entirely to the Society, and that that will be so whether or not the Extraction Agreement terminates at the same time. 10

(d) It follows from the conclusion advanced in the previous paragraph that immediately before the sale of any timber held in the log pond, that timber is owned by the Society, not by LDT. Such timber, moreover, has already been extracted from the forest. 20

(e) Where timber is sold from the log pond LDT submits that it is an impossible analysis of the transaction to describe it as LDT selling its own timber which it had extracted for its own benefit and had itself owned while in the log pond. There are, it is submitted, only two possible analyses of the transaction which could be correct in law. 30

Analysis A

LDT sells timber from the log pond as agent for the Society (making such sales through its sub-agents, Yong Brothers). Clause 1 of the Export & Works Agreement provides that the Society shall permit LDT to sell and export "on behalf of the Society" all the timber extracted etc. The financial provisions of the Export & Works Agreement merely regulate what amounts out of the proceeds of sale LDT is entitled to retain for itself and what amounts it has to account 40

for to its principal. On that basis the agent accounts to the principal for fixed amounts out of the proceeds of sales made on behalf of the principal, keeping the balance itself. Such an arrangement might strike some non-Malaysian observers as unusual, but it is submitted that - usual or unusual- it is perfectly possible in law.

Analysis B

10 When, via the agency of Yong Brothers, a contract is made for the sale of timber to a customer, at the same time a contract comes into force between the Society and LDT for LDT to buy the same amount of timber from the Society. A contractual relationship of that kind was recognised as a clear possibility, and indeed held to exist in the particular case, by the House of Lords in Michelin Tyre Co. Ltd. v Macfarlane (Glasgow) Ltd. (1917) 60 S. L. R. 35, and is common in commercial experience. Manufacturers of products such as motor cars frequently consign them to
20 dealers under arrangements whereby, as long as the items remain unsold, they continue in the ownership of the manufacturers, but, when a purchaser is found, simultaneous contracts are formed for the manufacturer to sell the item to the dealer and for the dealer to sell it on to the purchaser. LDT and the Society may well not have realised that their legal relationship was in accordance with this Analysis B, but as the speeches in the House of Lords in the Michelin case, supra, indicate, that does not in any
30 way prevent it being the correct analysis.

(f) If Analysis A set above is correct, LDT submits that two consequences follow

(i) The income earned by LDT under the Export & Works Agreement was, as is implicit in the description "agency fee" its remuneration for providing to the Society the service of selling the Society's timber on its behalf. It was not derived from the extraction of timber from the forest, and therefore is not liable to timber profits tax.
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(ii) As regards s. 39(1)(g), the three disputed amounts which LDT paid to or for the benefit of the Society never belonged beneficially to LDT at all. There is, therefore, no question of their ranking as deductions, allowable or otherwise, in the computation of

LDT's profits. Reference is made to the remarks of Lord Greene M. R. in Morley v. Tattersals, 22 T. C. 51 at 65. Even if the payments do operate as deductions in the computation of profits, they are not payments for the use of a licence or permit to extract timber from a forest, and are therefore not disallowed by s. 39(1)(g).

(g) If Analysis B set out in subparagraph (e) above is correct, then the same two conclusions follow, though for slightly different reasons. 10

(i) As regards timber profits tax the profits earned by LDT under the Export & Works Agreement derived from the purchase and re-sale of timber which had already been felled and extracted from the forest. Therefore the profits were not profits derived from the extraction of timber from the forest and were not liable to timber profits tax. 20

(ii) As regards s. 39(1)(g), the three disputed amounts paid by LDT to or for the benefit of the Society were not paid for the use of a licence or permit to extract timber from the forest, but were paid as the purchase price of felled timber which LDT re-sold in the course of its trade. Therefore s. 39(1)(g) does not prevent the deduction of them, and they are allowable under s. 33(1) of the Act, which lays down the general rule that there may be deducted outgoings and expenses wholly and exclusively incurred in the production of gross income from the source. 30

8. LDT therefore submits that the appeal should be allowed in principle with costs before Your Lordships and in the courts below and that the assessment should be remitted to the Special Commissioners to be adjusted accordingly, for the following among other 40

R E A S O N S

(1) BECAUSE the nature of LDT's profits derived from the Export & Works Agreement and the nature of the payments

made by LDT thereunder are questions of law capable of being reviewed by Your Lordships on appeal and are not questions of fact to be determined by the Special Commissioners.

(2) BECAUSE timber extracted by LDT and delivered to the log pond remained the property of the Society until it was sold to customers.

10 (3) BECAUSE therefore the only income derived by LDT from the extraction of the timber (and hence the only income derived by LDT liable to timber profits tax) was the amount of extraction charges earned by LDT under the Extraction Agreement.

(4) BECAUSE the income earned by LDT under the Export & Works Agreement was either -

(i) in the nature of remuneration to an agent for services supplied to a principal, or

20 (ii) profits from the simultaneous purchase and re-sale of timber which had already been extracted

and on neither footing could it be income derived from the extraction of timber so as to be liable to timber profits tax.

30 (5) BECAUSE if the balance of income earned by LDT under the Export & Works Agreement was in the nature of remuneration to an agent (as in (i) in reason (4) above) the disputed amounts payable by LDT to or for the account of the Society merely represented money belonging to a principal and accounted for to the principal by its agent.

40 (6) BECAUSE in that case the disputed amounts were properly left out of LDT's profit and loss account altogether and on no view fell to be disallowed under section 39(1)(g) of the Income Tax Act 1967 as sums payable for the use of a licence or permit to extract timber from a forest in Malaysia.

(7) BECAUSE if the balance of income earned by LDT under the Export & Works Agreement

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constituted profits from the simultaneous purchase and re-sale of extracted timber stored in the log pond (as in (ii) in reason (4) above), the disputed amounts payable by LDT to or for the account of the Society represented the purchase price paid by LDT for timber sold by LDT in the normal course of its trade.

(8) BECAUSE in that case the disputed amounts-

(a) were not payable for the use of a licence or permit to extract timber from a forest in Malaysia and therefore do not fall to be disallowed under section 39(1)(g) of the Income Tax Act 1967; and 10

(b) were expenses wholly and exclusively incurred in the production of income and therefore fell to be allowed as deductions under section 33(1) of the same Act. 20

ANDREW PARK

S. WOODHULL

No. 28 of 1978

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