Privy Council Appeal No. 43 of 1983

Mamor Sendirian Berhad *Appellant*

v.

The Director General of Inland Revenue *Respondent*

FROM

THE FEDERAL COURT OF MALAYSIA

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 10TH OCTOBER 1985

Present at the Hearing:

LORD KEITH OF KINKEL
LORD LOWRY
LORD BRANDON OF OAKBROOK
SIR DENYS BUCKLEY
SIR OWEN WOODHOUSE

*[Delivered by **Lord Keith of Kinkel**]*

This is an appeal against assessments to income tax, timber profits tax and development tax which on 7th July 1973 were made on the appellant (the "taxpayer") in respect of the assessment years 1971, 1972 and 1973. The total taxes assessed were $79,125.10 for 1971, $106,415.45 for 1972 and $112,500.00 for 1973, but the last figure was reduced to $30,835.05 by notice of reduced assessment dated 21st December 1974.

The relevant facts, as set out in the Case Stated by the Special Commissioners of Income Tax, who disallowed the taxpayer's appeal against the assessments, may be summarised as follows.

The taxpayer was incorporated on 14th May 1968 as a private limited company under the Companies Act 1965. The first clause of its Memorandum of Association set out the object of carrying on the business of planters and cultivators of *inter alia* palm oil. As is customary in such Memoranda, the following clauses set out a great number of other objects, not necessarily related in any way to that contained in the first clause. The nineteenth clause stated the

[35] object of carrying on business as timber merchants

and in other more or less ancillary activities such as that of shipowners and carriers by land and sea. At the time of the taxpayer's incorporation it was known that the Government of the State of Johore was contemplating a scheme involving the alienation of State land to private concerns for development purposes. By public advertisement on 21st August 1968 the Government announced its intention of alienating a total of 42,000 acres of virgin jungle land and 7,000 acres of other land for oil palm plantation development. Applications were invited for lots of 7,000 acres. A successful applicant for jungle land was to be required to pay a premium of $100 per acre and a refundable deposit of $70,000, but for the other land a premium of only $60 per acre, and no deposit, was to be paid. A successful applicant was also to be required to surrender 1,500 acres of the developed palm oil plantation to the Johore Development Corporation for re-alienation to smallholders. Earlier Government policy had been to alienate only detimbered State land for development purposes. The change of policy was designed to speed up the development process.

The taxpayer duly made application and received a notice dated 30th November 1968 stating that it had been allocated, upon certain conditions which were set out, Block 6 comprising about 7,000 acres of jungle land in the District of Kluang. The conditions included payment of the sum of $719,524.00, which the taxpayer duly made on 29th March 1969. This represented a premium of $100 per acre, which had been calculated by the Government authorities as including an element of $47 in respect of the right to extract timber. There was no evidence that this manner of calculation was known to the taxpayer.

On 1st June 1969 the taxpayer entered into an agreement with the State Government. This agreement narrated that the taxpayer (described as "the lessee") having been approved an area of approximately 7,000 acres of State land for the purpose of planting oil palm was desirous of developing the area and exploiting timber therein, the term "to exploit" being defined as meaning to fell and log timber and remove such timber from the area in which it had been felled. The agreement went on to oblige the taxpayer to develop the area at the rate of 1,000 acres per year, and at the beginning of the fifth year from the commencement of planting to hand over to the Government 1,500 acres fully planted with oil palm crops to the satisfaction of the Government. The Government agreed to pay the taxpayer the cost of developing the 1,500 acres, including that of felling, burning, clearing, planting, draining and maintaining the area, with interest at the rate of 3½ per cent per annum. The Government

further agreed to grant the taxpayer licences enabling it to exploit 1,000 acres of timber each year, in return for royalties payable in respect not only of timber actually cut and removed but also of timber which in the opinion of the Conservator of Forests or the District Forest Officer was economically utilizable but due to the taxpayer's failure had not been removed. In addition, a penalty of $20 per tree was imposed in respect of any tree of 5 feet girth or over at a height of 4½ feet from the ground not felled and removed by the taxpayer, and any timber not cut within one month of the expiry of an annual licence or not removed within three months of being cut was to become the property of the Government, to be disposed of as the latter deemed fit. Other clauses provided for the payment of a deposit and of advance royalties.

On 2nd June 1969 Block 6 was alienated to the taxpayer under a qualified title. On 3rd January 1970 the taxpayer entered into an agreement with a contractor for the extraction of the marketable timber from Block 6. This provided for the construction of a main road through the area by the contractor and for the extraction by him of timber of 16 inch girth and upwards consisting of profitable and marketable species at the rate of 100 acres per month, in return for payments to the contractor by the taxpayer at the rate of $20 per ton of timber extracted and delivered to stockpiles.

Logging operations commenced on 20th July 1970 under a regime approved by the Forest Department, involving *inter alia* that development of the first 1,000 acres could not be started till the first 2,000 acres had been cleared of timber, and that clearing of the third block of 1000 acres could not be started till the first 1000 acres had been planted with palm oil.

The taxpayer appointed a Singapore company as its agent to arrange the sale of cut timber to buyers, in exchange for an agreed sale price less costs, a sales commission also being payable to the company. Clearance of the land was delayed to some extent due to various causes, and by supplemental agreement between the taxpayer and the State Government dated 18th September 1972 the principal agreement dated 1st June 1969 was varied to the effect that the taxpayer was required to develop fully and plant with palm oil the whole of the first 1,500 acres by 31st December 1973, and the seven year period of the principal agreement was to be calculated from 1st June 1972.

During the assessment years 1971-73 only 2,000 acres in all were exploited for timber, but by the time of the hearing before the Special Commissioners (December 1976) only 300 acres out of the 7,000 were

yet to be planted with palm oil, and the agreed 1,500 acres had been surrendered, fully planted, to the Johore Development Corporation, payment at the rate of $300 per acre having been made to the taxpayer.

The Case Stated also contains certain findings related to the state of the taxpayer's share capital and its ownership from time to time, but these are of no relevance for the purpose of ascertaining the taxpayer's liability to taxation, and counsel for the respondent made no reference to them in the course of the hearing before the Board.

The Case Stated contains no question of law for the opinion of the Court. However, in paragraph 11(ii) the Commissioners say:-

> "... the question before us was whether such sums [viz. those received from the extraction and sale of timber from the land during the relevant basis periods] were received by the appellant in the course of development of the said land into a oil palm plantation and were capital receipts and not income from a separate business of timber operators carried on by the appellant or whether such sums were income chargeable to income tax, development tax and timber profits tax."

At this stage it may be mentioned that the taxpayer does not dispute that, if it was properly found liable to income tax, it was also liable to development tax and timber profits tax. Likewise, if there is no liability to income tax, neither of the other two taxes is exigible.

The question of law raised by the Case Stated is accordingly whether the Commissioners on the facts found were entitled to decide, as they did, that the taxpayer was liable to income tax for the relevant 3 years.

The Commissioners' reasons for their decision, as set out in paragraphs 11(viii), 12 and 13 of the Case Stated, were as follows:-

> "(viii) For the following reasons we agreed with the contentions of counsel for the respondent that there were two different activities, viz, the extraction and sale of timber from the said land and the development of the said land into an oil palm plantation and that in extracting and selling the said timber the appellant was commercially exploiting the said timber as set out in sub-paragraph (vii) above:-
>
> (a) The appellant was established only when it became known that the State Government was contemplating a scheme

to alienate State land to the private sector for development purposes. When applications were invited for participation in the proposed State Government oil palm plantation development programme, the appellant successfully applied for and was allotted 7,000 acres of virgin jungle land;

(b) The appellant applied for land ostensibly to participate in the proposed State Government oil palm development scheme and accepted the allotment of 7,000 acres of virgin jungle land with the condition that the State Government would grant the appellant the right to extract timber from the said land for which the appellant would enter into agreement with the State Government;

(c) In the agreement entered into between the appellant and the State Government it was stated that for the purpose of planting oil palm the appellant was desirous of developing the said land and exploiting timber thereon. We were of the considered opinion that the exploitation of timber and the development of the said land were two different activities;

(d) For the alienation of the said land a premium of $700,000 at the rate of $100 per acre was paid by the appellant. The latter sum included a forest premium of $47 per acre exclusively for the right to extract timber from the said land. Accountant for the appellant however contended that this division of the $100 premium was never communicated by the State Government to the appellant. In any event, non-communication of this information to the appellant by the State Government, in our opinion, had no bearing on the question of whether the sums received were capital receipts or revenue receipts. We are of the opinion that in exercising the right to extract timber from the said land for which the forest premium was paid the appellant was engaged in a trade of exploitation of timber and not in activities in the course of development of the said land into an oil palm plantation;

(e) We had the evidence of the Deputy Director of Lands and Mines, Johore, and the Kluang District Forest Officer that the State Government would not normally alienate land with standing timber for development purposes. The timber would have first to be extracted from the land under a licence from the Forest Department before it would be alienated for development under the National Land Code. The extraction of timber from any land and the development of such land need not be contemporaneous nor necessarily be by the same person. However, in this instant case, these two activities because of the terms and conditions of the alienation became the sole responsibility of the appellant;

(f) The appellant had agreed to develop the said land and exploit the timber thereon as stated in the preamble to the agreement of 1st June 1969, and in carrying out this agreement, the appellant had indeed been engaged in these two different activities;

(g) We found the timber extraction activities of the appellant were very similar to those of a timber operator and they were consistent with the claim by counsel for the respondent that there was an organised and systematic exploitation of timber on the said land. What actually took place was primarily the exploitation of profitable and marketable timber in West Malaysia and Singapore as stipulated in paragraph 3 of the agreement (Exhibit A1 - folio 39), and these activities could not have supported the appellant's claim that its sole business was development and conversion of the said land into an oil palm plantation. The appellant was indeed trading as a timber operator and was embarking on a trade when it exploited and sold the timber with the assistance of Syarikat Kilang Palan Low Nam Hui Sdn. Bhd. and Pan Singapore Timber Enterprises Company respectively.

12. A number of authorities were submitted to us by Accountant for the appellant which would tend to establish that standing timber on land was part of a capital asset

and that the disposal thereof for a capital sum or by reference to the volume of timber extracted was a receipt of capital. We, however, were of the opinion that these authorities could be distinguished from this appeal in that the appellant was given the right to extract timber for which a separate premium was paid. A further distinction would be that there were two different activities as found by us, i.e. the extraction and sale of timber and the development of the land.

13. We found that there were two separate and distinct activities, viz. the extraction and sale of timber from the said land and the development of the said land into an oil palm estate. Such extraction and sale of the said timber constituted the carrying on of a business of timber operators under section 4(a) of the Income Tax Act, 1967. We, therefore, decided that the sums received from the extraction and sale of the said timber for the relevant basis periods were income chargeable to income tax, development tax and timber profits tax."

The taxpayer's appeal came before Annuar bin Dato' Zainal Abidin J. in the High Court at Johor Bahru, and on 29th November 1979 he allowed it. He said:-

"In my opinion the Special Commissioners erred in law in that they proceeded in their inquiry on the basis of ascertaining if the appellant was carrying on business as timber operators. They should have inquired whether the felling and sale of timber was realisation of a capital asset effected as incidental activity to the main activity of clearing the land for oil palm development or whether by doing so they were carrying on a business of felling and selling timber."

He concluded:-

"In the circumstances of the facts as found by the Special Commissioners and drawing the reasonable inferences from them the extraction and sale of timber and the development of the land into oil palm were one activity for the purpose of tax. The sum received by the appellant from the extraction and sale of timber from the said land for the relevant basis periods were sums received in the course of development of the said land into an oil palm [plantation] and therefore are not chargeable to income tax, development tax and timber profits tax."

The Director General of Inland Revenue appealed to the Federal Court of Malaysia, which by judgment of the Court dated 14th May 1982 (Wan Suleiman, Ag. C.J. Malaya, Syed Othman and Abdul Hamid F.JJ.) reversed the judgment of the learned judge and restored the determination of the Commissioners. The Court took the view that the learned judge had contravened the principle of *Edwards v. Bairstow* [1956] A.C. 14 by substituting his own inferences from the primary facts for those legitimately drawn by the Special Commissioners. The taxpayer now appeals, with leave of the Federal Court, to His Majesty the Yang di-Pertuan Agong.

Section 4(a) of the Income Tax Act 1967 provides:-

> "Subject to this Act, the income upon which tax is chargeable under this Act is income in respect of -
>
> (a) gains or profits from a business, for whatever period of time carried on."

The fundamental question in the case is whether or not the receipts from the sale of timber in respect of which the taxpayer has been held liable to income tax are income falling within this description. That is a question of mixed fact and law, since an element of statutory construction is involved. A pre-requisite to the application of the provision is that the taxpayer should have been carrying on a business with a view to gain. Whether or not he was doing so here is a matter of inference from the primary facts found. The Commissioners drew the inference that the taxpayer was indeed carrying on such a business, that of a timber operator. That inference is one which cannot be interfered with on appeal, unless it is such as no reasonable body of Commissioners, correctly directing themselves in law, could properly have drawn: *Edwards v. Bairstow*, *supra*.

If the taxpayer in this case had acquired the 7,000 acres of forest land for no other purpose than that of cutting and selling the timber on it at a profit, even without any intention of re-planting with timber and carrying on continuing operations, then clearly that would have been a business venture, an adventure in the nature of trade. That was the nature of the taxpayer's activity in *Rutledge v. C.I.R.* 14 T.C. 490, the principle of which the Federal Court considered to be applicable in the present case. But it was crucial to the decision in *Rutledge* that the taxpayer's purchase, an isolated speculation in toilet paper, was made with no other purpose than that of re-sale at a profit. That is not the kind of inference which can rightly or indeed possibly be drawn in the instant case.

The agreement dated 1st June 1969 between the Government of Johore and the taxpayer must be considered as a whole. The preamble stated that the taxpayer was desirous of developing the area of 7,000 acres and exploiting timber therein, but it also stated that the taxpayer had been approved the area for the purpose of planting palm oil, and it also defined "exploiting" in the sense of felling and extracting timber without any reference to sale of the timber.

The surrounding circumstances show that it was Governmental policy to secure the development of large areas of forest land as palm oil plantations and that a substantial part of the areas so developed should be made available for smallholders. That was the whole purpose of the agreement. The felling and extraction of timber was the first step, but only the first step, towards the achievement of that purpose. It was also necessary to carry out burning, clearing of stumps, draining and planting with palm oil plants, activities which would never be undertaken by an operator whose sole purpose was to realise the timber at a profit. It was, of course, necessary for the taxpayer to obtain felling licences and to pay royalties on timber sold, as would any operator interested in realising timber as a profit, but the Government had undertaken to grant such licences and its policy objectives could not otherwise be achieved. Further, the taxpayer was not only entitled to fell and extract timber, but taken bound to fell and extract all trees over a certain girth with a penalty in the event of failure and also to pay royalties upon all economically utilizable trees not extracted. The felling regime itself was to be under the strict supervision of the Forest Officer. Finally, 1,500 acres of the area, when fully developed, were to be handed back for distribution to smallholders, the taxpayer to receive in return the cost of development with certain interest.

There can be no doubt whatever on the primary facts that the taxpayer was obliged to, intended to and did develop the 7,000 acres as an oil palm plantation. The felling and extraction of timber was a necessary and obligatory step in that process, which was an extremely expensive one, and obviously the sale of the timber was a prudent and reasonable means of counterbalancing and mitigating that expense. In the end of the day the taxpayer's operations resulted in the transformation of a capital asset in the shape of 7,000 acres of virgin forest, which it had acquired for $719,524, into a capital asset of a different character, namely that of an oil palm plantation.

The Commissioners drew from the primary facts the inferences that the taxpayer was carrying on two separate and distinct activities, the extraction and

sale of timber from the land and the development of the land as a palm oil plantation, and that the extraction and sale of timber constituted the carrying on of a business of timber operators. Their Lordships have no hesitation in reaching the conclusion that these were inferences which the Commissioners were not entitled to draw. The extraction of timber was inseparable from the process of developing the land as an oil palm plantation. The development was impossible without extracting the timber, and that is why the taxpayer was obliged to do so under its agreement with the Government of Johore. Sale of the timber was an obviously sound economic course to take with a view to mitigating the cost of development.

The reasons given by the Commissioners for their decision consist for the most part of repeated assertions that the taxpayer carried on extraction of timber and development of the land as two different activities. That is a view of the facts which their Lordships, as they have said, regard as untenable. By their use of the word "ostensibly" in paragraph 11(viii)(b) the Commissioners appear to be suggesting, without any warrant whatever, that the taxpayer had some oblique motive for entering into the agreement with the Government of Johore. In sub-paragraph (viii)(d) and again in paragraph 12 the Commissioners appear to be much influenced by the circumstance that the price of $100 per acre required by the State Government included an element of $47 in respect of the right to extract timber. Counsel for the respondent disclaimed any suggestion that the taxpayer was aware of this manner of calculation of the price on the part of the State authorities, and it is quite irrelevant to a consideration of the significance from the inferential point of view of the taxpayer's business activities. In so far as they were influenced by this circumstance the Commissioners misdirected themselves in law by taking into account an irrelevant consideration. The Commissioners also seem to have regarded it as important, as appears from sub-paragraph (viii)(g), that the taxpayer used the agency of a contractor to extract the timber and that of a Singapore company to sell it. That circumstance cannot, in their Lordships' view, reasonably add anything of materiality to the fact that the taxpayer did extract and sell the timber.

Their Lordships are accordingly of opinion that the only reasonable inference open on the primary facts is that the taxpayer was during the relevant years carrying on no more than the project of developing the 7,000 acres as a palm oil plantation, and in particular that it was not carrying on a business of timber operators.

That does not quite conclude matters, because section 4 of the Income Tax Act 1967, the opening words of which have already been quoted in connection with paragraph (a), also contains paragraph (f) in these terms:-

> "(f) gains or profits not falling under any of the foregoing paragraphs."

So even though the taxpayer was not carrying on business as timber operators the relevant receipts might yet be caught for tax purposes if they were of an income character. On the view which they took as to the carrying on by the taxpayer of a business the Commissioners did not require to consider this aspect. In their Lordships' opinion the receipts in question are properly to be regarded as having a capital and not an income character. The timber standing on the 7,000 acres was part of a capital asset which the taxpayer acquired by payment of a capital sum. It expended further capital sums on the development of the land, and in mitigation of that expenditure it realised and disposed of timber which formed part of its original capital asset.

For these reasons their Lordships will advise His Majesty the Yang di-Pertuan Agong that the appeal should be allowed and the order of Annuar bin Dato' Zainal Abidin J. restored. The respondent must pay the appellant's cost here and before the Federal Court.