



EXERCISING DISCRETION IN IMPOSING PENALTY: Is Good Faith a Relevant Factor?

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In recent tax appeals such as *OPD Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri*², *SETM Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri*³ and *SM Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri*⁴, the Special Commissioners of Income Tax (the Special Commissioners) have consistently held that a penalty under S.113(2) of the Income Tax Act 1967⁵ (the ITA) should not be imposed in instances where the taxpayer had acted in good faith⁶.

Should the Inland Revenue Board (IRB) consider good faith as a relevant factor in exercising its discretion to impose a penalty? We highlight the circumstances that would give rise to good faith.

SECTIONS 113(1) AND (2) OF THE ITA

Unlike S.113(2) of the ITA, S.113(1) expressly provides that good faith is a defence available to taxpayers in instances

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2. (2009) MSTC 3,846

3. Rayuan PKCP(R) No 14/2008

4. Rayuan PKCP(R) No 26/2008

5. [Act 53]

6. *Datuk D P Naban and S. Saravana Kumar represented the taxpayers in OPD Sdn Bhd, SETM Sdn Bhd and SM Sdn Bhd.*

where a penalty is imposed under that provision. This has led the IRB to contend that good faith is not a factor that it needs to consider in imposing penalty under S.113(2).

In SETM and SM, the IRB made reference to the decision of the Special Commissioners in *KT & Co v Ketua Pengarah Hasil Dalam Negeri*⁷ in an attempt to justify its decision. In that case, the Special Commissioners held that:

“The Appellant also claimed good faith as a defence. They argued that since it is provided as a defence under S.113(1) of the Act, it should apply with equal force under S.113(2) as well. The short answer to the argument is that it is not applicable under S.113(2) for the simple reason that no provision has been made for it therein...”

However, the facts in *KT & Co* can be clearly distinguished from those of SETM and SM as the taxpayers in the latter cases did not attempt to expand the defence of good faith available under S.113(1) and (2).

Instead, the taxpayers argued that the IRB should have taken into account the fact that they had acted in good faith before considering whether a penalty under S.113(2) should be imposed.

DISCRETIONARY PROVISION

It must be observed that S.113(2) is a discretionary provision as it clearly confers discretion on the IRB as to whether a penalty should be imposed or not. Support for this view can be found in the High Court decision of *Kim Thye Co v Ketua Pengarah Jabatan Hasil Dalam Negeri, Kuala Lumpur*⁸, where Richard Talalla J commented (at p 2510):

“As I see it subs.1 of S.113 is couched in mandatory terms but conditioned whereas subs.2 is expressed in terms which are discretionary.”

“Good faith” is not defined under the ITA. The Indian High Court has defined it as “an orientation of honest intention and want of any deliberate attempt to mislead”. It includes an act done with a bona fide belief, even if such belief is a mistaken one.

In that regard, the authors submit that the IRB, in exercising its discretion, must take into account all relevant factors and circumstances of the case and should not act mechanically.

In his authoritative work, *Administrative Law of Malaysia and Singapore* (3rd Ed), Professor M P Jain wrote:

“When discretion is conferred on an authority, it must personally exercise the same; it must apply its own mind to the facts and circumstances of each case and come to its own decision. If authority acts without applying its mind to the case before it, then the action or decision taken by it will be bad because the authority has not exercised its discretion.”

The above view was endorsed and applied by Richard Malanjum J in *Awang Tengah Ag Amin v Sabah Public Service Commission & Anor*⁹.

As to what amounts to relevant factors, our courts have held that the list is non-exhaustive as it all depends on the circumstances of each case. However, for

the purposes of this article, the authors will discuss whether good faith is a relevant factor in the context of S.113(2).

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NO UNFETTERED DISCRETION

The IRB’s contention that it need not be satisfied whether the taxpayer had acted in good faith for the purposes of S.113(2) is nothing new, having been raised nearly 20 years ago in *Kim Thye*.

However, in a well-articulated judgment, the Supreme Court in *Ketua Pengarah Hasil Dalam Negeri v Kim Thye & Co*¹¹ firmly rejected the IRB’s contention, where Peh Swee Chin SCJ commented that (at p 29):

“It was argued to the effect, that on a comparison of S.113(1) and 113(2) of the Act, the Revenue [Director General of Inland Revenue], when imposing the penalty, need not be satisfied that the incorrect return or information was given in good faith whereas such good faith would preclude a conviction by the court in respect of S.113(1).”

The learned judge found from S.113(2) a discretion vested in the Revenue, as to whether to impose or not, a penalty thereunder. His Lordship said:

‘... He is given a discretion, a discretion which to my mind he cannot exercise at whim or fancy but after due consideration of all relevant facts and circumstances...’

His Lordship clearly held that the IRB has no unfettered discretion in imposing a penalty under S.113(2). Peh Swee Chin SCJ’s decision is evident from the following passage of *Ketua Pengarah Hasil Dalam Negeri* (at pp 29-30):

7. (1996) MSTC 2,594

8. [1991] 3 CLJ 2507

9. [1998] 2 CLJ Supp 409

10. See *Public Carriers Truck Owners’ Association v CIT 210 ITR 36 (Raj)*

11. [1993] 1 BLJ 25

EXERCISING DISCRETION IN IMPOSING PENALTY: IS GOOD FAITH A RELEVANT FACTOR?

“The Revenue seemed to have harked back to the discarded theme of unfettered discretion, and if they did, and we have little doubt that they did, it would be of salutary effect to remind ourselves of the inspiring words of Raja Azlan Shah, Ag CJ (as he then was) in *Pengarah Tanah dan Galian, Wilayah Persekutuan v Sri Lempah Enterprise Sdn Bhd* [1979] 1 MLJ 147 in which, while dealing with a claim for unfettered discretion, his Lordship said:

I cannot subscribe to this proposition for a moment. Unfettered discretion is a contradiction in terms... Every legal power must have legal limits, otherwise there is dictatorship. In particular, it is a stringent requirement that a discretion should be exercised for a proper purpose, and that it should not be exercised unreasonably. In other words, every discretion cannot be free from legal restraint: where it is wrongly exercised, it becomes the duty of the courts to intervene... In these days when government departments and public authorities have such great powers and influence, this is a most important safeguard for the ordinary citizen: so that the courts can see that these great powers and influence are exercised in accordance with law.’

The authors would also like to draw reference to the High Court’s decision in *Kim Thye*, where Richard Talalla J made the following comments (at p 2510):

“The Director General may require payment of the penalty. He is not bound to require such payment. He is given a discretion, a discretion which to my mind he cannot exercise at whim or fancy but after due consideration of all relevant facts and circumstances. It seems to me that the Director General would have to consider whether the incorrect return or incorrect information was respectively made or given dishonestly with intention to evade payment of tax or possibly even negligently and

then, and only then, mete out the punishment...”

Following the High Court and Supreme Court decisions in *Kim Thye*, the authors are of the view that there is no basis for the IRB to continue to contend that good faith is confined to S.113(1) alone. In exercising its discretion to impose penalty under S.113(2), it is necessary that the IRB considers the fact whether the taxpayer had acted in good faith.

It must be appreciated that in a tax appeal, the burden of proof is on the taxpayer. As such, it is incumbent on taxpayers to establish that they have acted in good faith and that the IRB had failed to take that factor into account in exercising its discretion.

CIRCUMSTANCES GIVING RISE TO GOOD FAITH

It must be appreciated that in a tax appeal, the burden of proof is on the taxpayer¹². As such, it is incumbent on taxpayers to establish that they have acted in good faith and that the IRB had failed to take that factor into account in exercising its discretion.

In *SETM*, the Special Commissioners, in ruling that the taxpayer was entitled to claim reinvestment allowance on the capital expenditure incurred to construct toilets, a warehouse, office rooms, meeting rooms, staircase, lift lobby and surau, held that:

“... the facts of this case show [that] the Appellant has acted in good faith, made full disclosure and obtained professional advice; and therefore we order the penalty imposed be waived accordingly”.

Among others, the circumstances that taxpayers may rely on to establish good faith are that they had:

- made full disclosure in the tax returns submitted to the IRB;
- kept all the relevant documents and invoices in order and were able to produce them to the IRB as and when requested;
- consulted a reputable tax agent for professional advice in preparing and submitting their tax returns; and
- obtained legal advice from a reputable tax lawyer in managing contentious tax matters.

In contending that the IRB had failed to exercise its discretion under S.113(2) by not taking into account the fact that the taxpayer had acted in good faith, the authors are of the view that taxpayers must be able to establish some of the circumstances listed above.

CONCLUSION

In instances where taxpayers have acted in good faith, i.e. it can be shown that they had no intention to evade tax and had exercised reasonable care by obtaining professional advice, the IRB should take these factors into account when exercising its discretion with regard to penalty under S.113(2) of the ITA in the event an adjustment is made to the assessments made by the taxpayers. ■

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12. See paragraph 13 of Schedule 5 of the ITA