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Gains Arising From Property Disposal To REIT Are Not Subject To Income Tax

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Real Property Gains Tax (RPGT) is a tax imposed on capital gains arising from the disposal of real property. Under Section 3(1) of the Real Property Gains Tax Act 1976 (RPGTA), any chargeable gain accruing on the disposal of real property is subject to RPGT. However, in 2003, the Minister of Finance issued the Real Property Gains Tax (Exemption) Order (No.4) 2003 (Exemption Order), which provides an exemption from RPGT for any person who disposes of chargeable assets to a Real Estate Investment Trust (REIT) that has been approved by the Securities Commission.

In the recent case of *ELSB v Ketua Pengarah Hasil Dalam Negeri*, the Revenue took the position that the Exemption Order did not apply and subjected the gains to income tax. The Special Commissioners of Income Tax (SCIT) ruled in favour of the taxpayer, where it was held that the Exemption Order was applicable and thus, the gains made by the taxpayer from the disposal of a warehouse to a REIT cannot be subjected to income tax. This is a significant legal ruling as this is the first ruling of its kind by the SCIT in relation to the applicability of the Exemption Order and Section 4(a) of the Income Tax Act 1967 on gains arising from disposal of property to a REIT.

The taxpayer was successfully represented by the firm's Tax, SST & Customs Partner, S. Saravana Kumar together with Associate, Felicia Wong Sie Ying.

Background Facts

ELSB (the Taxpayer) was a company engaged in property leasing and investment. On 23.7.2012, it acquired a warehouse in Shah Alam from a REIT for RM 23,600,000. ELSB's intention was to earn long-term rental income by renting out the warehouse and capital appreciation by owning the warehouse on a long term basis.

In 2013, ELSB leased the warehouse for 8.5 years to a multinational company and ELSB agreed to address the wear

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and tear issues in the warehouse (such as plumbing and wiring) as identified by the tenant in their asset due diligence report. ELSB earned market rate rental income every month from the tenant and the rental income was subjected to income tax.

Subsequently, on 10.6.2014, nearly 2 years after acquiring the warehouse, ELSB received an offer to buy the warehouse for RM 52,500,000 from the same REIT (which sold the warehouse to ELSB). As the offer price was more than double the acquisition price, ELSB proceeded to dispose of the warehouse to the REIT. ELSB duly submitted the RPGT returns for the year 2014 and claimed RPGT exemption on the gains made pursuant to the Exemption Order. The Revenue processed the RPGT return and did not subject the gains to RPGT in accordance with the Exemption Order. The Revenue also issued a RPGT clearance certificate to ELSB on 24.2.2015.

In 2017, the Revenue conducted a tax audit on ELSB. Notwithstanding the issuance of the clearance certificate and the Exemption Order, the Revenue changed its position and took the view that the disposal of the warehouse was a trading activity. The Revenue subjected the gains to income tax pursuant to Section 4(a) of the ITA as business income and issued an assessment for RM 7,231,103.96, for the YA 2014 on 27.11.2017, pertaining to the same gains from the disposal.

Legal Position

NYF Realty Sdn Bhd v Comptroller of Inland Revenue [1974] 1 MLJ 182 has set the tone for distinguishing between capital and trading receipt for tax purposes. In order to determine this, our courts rely on the "badges of trade" test, comprising these aspects:

- (a) Subject matter of transaction.
- (b) Period of ownership.
- (c) Frequency of transaction.
- (d) Alteration of property to render it more saleable.
- (e) Methods employed in disposing of the property.
- (f) Circumstances responsible for the sale.

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The SCIT's Ruling

In ELSB's appeal, the taxpayer acquired the warehouse in Shah Alam because of its strategic location and potential capital appreciation. The immediate aim was to generate reasonable returns by renting out the warehouse. The SCIT accepted ELSB's intention was to hold the warehouse as an investment based on various factors such as:

- (a) ELSB's primary business was property investment.
- (b) No prior involvement in trading activities.
- (c) The warehouse was rented out to generate rental income.
- (d) The consistent treatment of the warehouse as a non-current asset (i.e. fixed asset) in the audited accounts.
- (e) The nature of the warehouse made it not easily tradable and ELSB was not in the business of buying and selling warehouses.
- (f) The warehouse was disposed of within 2 years as ELSB received a very good offer from the buyer and ELSB did not take any steps to procure a buyer or advertise the warehouse for sale.
- (g) The renovation works undertaken by ELSB on the warehouse were in fulfilment of its obligations as a landlord and to address the wear and tear issues.

The SCIT also commented on the argument raised by the Revenue that ELSB disposed of the warehouse to the same REIT from which it had originally acquired the property. The SCIT went on to examine whether the original vendor, who had initially sold the warehouse to ELSB, subsequently becoming the buyer, had any impact on the character of the warehouse. The SCIT accepted that this fact did not change the character of the warehouse as an investment asset or the intention of ELSB to hold the warehouse as an investment.

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The SCIT also did not accept that Revenue's contention that ELSB's director has experience in real estate made him an expert in property trading. This argument was not relevant in determining the intention of ELSB or the character of the warehouse as to whether it was an investment or otherwise. This was because the warehouse was acquired, owned, and disposed of by ELSB and not the director in his personal capacity.

Conclusion

Based on the evidence presented, the SCIT concluded that ELSB had successfully proven that the gains arising from the disposal of the warehouse were capital receipts. This case serves as a reminder to understand the interaction between the provisions of the ITA and the RPGTA. The SCIT's decision to uphold the taxpayer's arguments reaffirms the paramount importance of good record keeping including a clear and consistent accounting treatment.

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