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Court Of Appeal Rules Disposal Of Warehouse Is Not Subject To Income Tax

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Last Monday, the Court of Appeal in *Ketua Pengarah Hasil Dalam Negeri v Exceptional Landmark Sdn Bhd* unanimously dismissed the Revenue's appeal and upheld the concurrent decisions of the Special Commissioners of Income Tax (SCIT) and the High Court that the gains arising from the disposal of a warehouse to a real estate investment trust (REIT) are not subject to income tax.

The taxpayer in this matter was successfully represented by the firm's Tax, SST & Customs Partner, S. Saravana Kumar together with Senior Associate, Dharshini Sharma.

Background Facts

The dispute arose from the taxpayer's disposal of a warehouse located in Shah Alam. The warehouse was acquired by the taxpayer in July 2012 for RM 23.6 million from a REIT. The taxpayer undertook repair and maintenance works to make the warehouse tenantable and secured a multinational company as a long-term tenant under an 8.5-year lease.

In August 2014, approximately two years after the acquisition, the same REIT which had sold the warehouse to the taxpayer approached the taxpayer and offered to purchase the tenanted warehouse for RM 52.5 million. In view of the lucrative offer, the taxpayer decided to sell the warehouse back to the REIT.

Following the disposal, the taxpayer took the position that the gains arising from the disposal of the warehouse were real property gains and submitted the real property gains tax (RPGT) return to the Revenue. As the warehouse was sold to a REIT, the taxpayer was exempted from RPGT by virtue of the Real Property Gains Tax (Exemption) (No. 4) Order 2003 (Exemption Order), which exempts disposal of chargeable assets to REITs from RPGT. The Revenue accordingly issued a certificate of clearance to the taxpayer.

In November 2017, the Revenue changed its position and, without first discharging the RPGT certificate of clearance issued earlier, raised a notice of additional assessment for income tax and penalty totaling RM 7,231,103.96. The Revenue claimed that the disposal of the warehouse should instead have been taxed under the ITA as a gain arising from an adventure or concern in the nature of trade.

The taxpayer successfully challenged the Revenue's decision before the SCIT. The Revenue's appeal to the High Court was dismissed, and the Revenue further appealed to the Court of Appeal.

The Badges Of Trade Analysis

The Revenue's Contention

Before the Court of Appeal, the Revenue argued that the SCIT and the High Court had erred in law by failing to properly apply the badges of trade test in *Lower Perak Co-operative Housing Society Berhad v Ketua Pengarah Hasil Dalam Negeri* [1994] 2 MLJ 713 and failed to recognise that the disposal of the warehouse exhibited characteristics of a trading transaction.

The Revenue submitted that the taxpayer's subsequent conduct should be considered together with its intention at the time of acquiring the warehouse, especially since they only owned the warehouse for about 2 years.

The Revenue further contended that the taxpayer's directors were also directors and shareholders of the purchasing REIT and possessed specialised knowledge of the real estate and REIT sectors. Accordingly, they were positioned to facilitate a profitable disposal without the need for conventional marketing efforts. The Revenue argued that these circumstances ought to have been treated as badges of trade.

The Taxpayer's Contention

The taxpayer maintained that the Revenue's appeal did not raise any error of law, but was, in substance, an attempt to rehear the findings of fact that were properly made by the SCIT and affirmed by the High Court.

Applying the badges of trade test, the taxpayer submitted that the SCIT and the High Court had properly and cumulatively assessed the relevant badges of trade, which pointed uniformly towards investment rather than trading activity:

- The warehouse was the taxpayer's only property;
- The taxpayer had entered into a genuine long-term lease of the warehouse;

- It was consistently treated as a non-current asset in the taxpayer's audited accounts;
- The taxpayer had undertaken no marketing or resale efforts; and
- The disposal of the warehouse was prompted solely by an unsolicited and lucrative offer.

The Taxpayer explained that the sale was prompted solely by an unsolicited offer at approximately 22% above the prevailing market value, which constituted a sum that would otherwise have taken close to 20 years to generate through rental income alone. Reference was made to the Court of Appeal’s ruling in *ALF Properties Sdn Bhd v Ketua Pengarah Jabatan Hasil Dalam Negeri* [2005] 3 CLJ 936 which recognised that the sale of a property following an irresistible offer by chance may be consistent with the ordinary conduct of a reasonable investor and does not, without more, constitute an adventure in the nature of trade.

On the Revenue's reliance on common directorships, the taxpayer submitted that the relevant directors had abstained from voting on the REIT's decision to repurchase the warehouse. The transaction was also subject to independent regulatory approval by the Securities Commission and approval by the REIT’s unit holders. These circumstances negated any suggestion that the disposal had been orchestrated or influenced by the common directorships or shareholdings.

The Court Of Appeal’s Decision

The Court of Appeal held that the central issue was whether the taxpayer's disposal of the warehouse, approximately two years after its acquisition, could properly be characterised as giving rise to a revenue gain rather than a real property gain.

Having considered the decisions of the SCIT and the High Court, the Court of Appeal found that the SCIT had properly considered and applied the relevant badges of trade in arriving at its findings of fact, and that the High Court had correctly declined to disturb those findings, there being no perversity, unreasonableness or inconsistency with the evidence or the primary facts established before the SCIT. Accordingly, the Court of Appeal held that it was not moved to interfere with the concurrent decisions of the SCIT and the High Court, and dismissed the Revenue’s appeal.

Further, by agreement between the parties, the Court of Appeal ordered that the Revenue refund the income tax paid by the taxpayer by 31.12.2026.

Commentary

This decision, now affirmed at three levels: the SCIT, the High Court and the Court of Appeal, provides strong reinforcement of the distinction between capital gains and trading income. It also reaffirms that the badges of trade must be assessed cumulatively and holistically in the context of the taxpayer’s conduct as a whole, rather than by isolating individual factors that may point towards trading activity.

The Court of Appeal's ruling reinforces that the mere fact that a property is disposed of shortly after acquisition or that the taxpayer possesses relevant industry knowledge, does not by itself establish that the property was acquired as trading stock.

The manner in which the property is held and used, the taxpayer's accounting treatment, the absence of resale or marketing activities, and the circumstances leading to the eventual disposal may collectively be decisive in determining the true character of the gain.

The decision is also significant in recognising that an attractive and unsolicited offer may provide a legitimate commercial reason for an investor to realise an investment. The acceptance of such an offer, even where it results in a substantial gain shortly after acquisition, does not without more convert an investment property into trading stock or make the resulting gain taxable as an adventure or concern in the nature of trade.

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