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Crowe Perspectives

Badges of Trade

Factors to consider on whether trade exists

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Introduction

Are profits made on the sale of art pieces, jewellery and collectibles taxable? Are proceeds from the sale of properties or shares subject to tax? Once there is a disposal of asset, the question that is always being asked is whether the gain on disposal is subject to tax. In ascertaining the taxability of such gains or receipts, the first task is to determine whether such gains or receipts arise from a capital transaction or a revenue transaction.

If a gain is treated as revenue in nature rather than capital in nature, the gain may be subjected to income tax under the Income Tax Act, 1967 (the Act). On the other hand, gains which are capital in nature are not taxable in Malaysia, except for gains derived from disposal of real properties or shares in real property companies.

Whether a gain arising from a transaction is capital or revenue in nature would depend on the facts and circumstances surrounding the transaction.

Gains from transactions conducted in the ordinary course of carrying on a business or consist of an element of an adventure in the nature of trade would be revenue in nature. On the other hand, gains from transactions that are one-off such as realisation of a long-term investment may indicate gains that are capital in nature.

The Act does not prescribe the circumstances an income or a gain is considered as a capital or revenue in nature. In practice, the principles laid down by the Courts in precedent tax cases collectively known as “badges of trade” are used as a guide in determining whether a person is carrying on trading activities or otherwise.

Badges of trade

The characteristic features of a trading activity, or the badges of trade as listed below, are used to test the existence of a trade or an adventure in the nature of trade:

- Motive or intention
- Trading interests in the same or similar field
- Nature of the asset
- Period of ownership
- Frequency of transactions
- Circumstances responsible for the realisation
- The way the sale was carried out
- Improvement made on the asset
- The method of financing

Motive or intention

If an asset is acquired with an intention to make a quick profit at the outset, it could indicate that trading activity exists. On the other hand, if the asset has been originally purchased with a view to hold it as an investment for capital appreciation, the gain from the subsequent sale would generally rank as a capital gain which is not subject to income tax.

Trading interests in the same or similar field

If the transaction undertaken is in line with the ordinary business of a taxpayer, then the transaction will be construed as a trade transaction. On the other hand, if it is far removed from the taxpayer's normal business activity, it may not amount to a trade transaction.

Nature of the asset

The manner an asset was acquired is an indicator of whether it was acquired for resale or that it was acquired for private use or as an investment. If it is inherited or gifted, it is a good indication that the asset was not acquired with a view to sale for profit.

Where an asset itself does not produce income or personal enjoyment to its owner merely by virtue of ownership, it is usually held to be trading in nature. On the other hand, an asset which was bought for own use and enjoyment with no indication of quick resale would generally not be regarded as a trading transaction. For example, a painting is acquired and hung on the living room wall, then this is likely to be considered as an investment rather than a trading asset.

However, if an asset is acquired in a very large quantity and cannot be retained for personal use, it is a pointer towards trade, not of enjoyment. For example, a taxpayer purchased one hundred boxes of milk powder in one single transaction, greatly in excess of what could be used by himself and his family, the transaction is more likely to be in the nature of trade rather than for personal enjoyment.

Period of ownership

Generally, an item purchased as an investment is often held for a long period of time whilst an item purchased for trade will be disposed of within a relatively short term in order to make profit. Hence, the longer the period of ownership of an item before its disposal, the stronger is the argument that the item is not purchased for trading purposes, but for investment.

Frequency of transactions

If there is a series of similar transactions, it may tend to indicate that the purpose of acquisition is for a profit-making undertaking or scheme. If the profit is derived from an isolated transaction where the taxpayer takes an occasional swipe to make some money, it would usually be viewed as capital gain rather than profit which is related to a business.

Circumstances responsible for the realisation

If the sale is occasioned by an unanticipated need for funds or following an unsolicited offer, such facts will tend to indicate that the sale is not made pursuant to a profit-making scheme. If the sale is part of a resale scheme for a quick profit, it may point towards a trading transaction.

The way the sale was carried out

If the sales have been conducted via an organized activity, such as carrying out extensive advertising, opening of an office, employment of sales staff, etc., it would tend to indicate the presence of a profit-making undertaking.

Improvement made to the asset

If material alterations or improvements have been made to the asset acquired or that its character or quality has been changed to make it more readily marketable, it would tend to indicate a profit-making undertaking. However, if an asset was clearly acquired for other purposes and subsequent improvement was done to render it more saleable after it was no longer useful for such original purpose, it shall not cause the gain to be taxable. For example, renovation work was carried out prior to disposal of a residential house of which the owner had been living for more than 10 years, the renovation work done shall not frustrate the original intention to acquire the property, which was clearly not for trading.

The method of financing

A short-term loan is usually taken to purchase trading stock and the taxpayer would rely solely on the future disposal at a profit to repay the borrowings. On the other hand, a long term loan is usually taken to finance long-term investment.

Besides, the financial ability of the taxpayer to acquire the asset is an indicator of whether the asset is acquired for long term investment. In the case where adequate capital or reserves exist to finance long term assets, the taxpayer would be in a stronger position to maintain itself as a long term investor.

Summary

Whether the gains would be regarded as profits attributable to trading activities (which are taxable) or profits from sale of investments (which are not taxable) would be a question of fact and depend on whether any badges of trade elements exist from the taxpayer's conduct from the point of acquisition to the point of disposal.

The fulfilment of either one or more of the above factors in itself may not be conclusive that trading activities are being carried out. Usually, an in-depth analysis of the facts of the case would be required and all factors are to be viewed in totality to reinforce the treatment of the gain. The onus of proof on whether an asset is to be regarded as a long-term investment or as a trading asset lies with the taxpayer to justify. Documentations such as sale and purchase agreements, minutes of board meeting, availability of funds at the time of acquisition of the asset and accounting classifications are required to substantiate a long-term investment motive.

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Need assistance on these matters?
Please contact us if you wish to seek clarification on any of these issues.

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