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TECHNICAL

Direct Taxation

TAX CASE UPDATE

Whether capital expenditure on "SAP System" qualifies for reinvestment allowance under Schedule 7A of the Income Tax Act 1967 (ITA)

KPHDN v MARIGOLD INDUSTRIES (M) SDN. BHD.

High Court of Malaya at Kuala Lumpur
Civil Appeal No: R1-14-12-10/2014
Date of Judgment: 19 January 2016

Facts and Issues:

This is an appeal by the Director General of Inland Revenue (DGIR) against the decision of the Special Commissioners of Income Tax (SCIT) who allowed an appeal by the respondent (the Taxpayer) against the DGIR's decision to raise the following:

(a) notices of additional assessment (Form JA) with penalties for the years of assessment (YA) 2003, 2004 and 2005; and

(b) notices of non-chargeability of income (Form NL) for YA 2001, 2002 and 2006.

Background – The Taxpayer was incorporated on 1.4.1979 and carries on the business of manufacturing and selling rubber gloves. It has a factory in Kulim. In YA 2001 to 2006, the Taxpayer claimed reinvestment allowance (RA) under Sch. 7A of the ITA. (All provisions cited hereinafter are from the ITA unless otherwise stated.)

The DGIR conducted a field audit on the Taxpayer in February 2009. Following the audit, Taxpayer was informed (via a letter from the DGIR dated 12.11.2009) that the Taxpayer's claim for RA amounting to RM5,388,385 was disallowed. The Taxpayer had incurred capital expenditure for the following items:

(a) upgrading of the factory; new scheduled waste sore; flammable chemical store; road widening; new Research and Development (R&D) laboratory; new building for compounding; electric mainboard for R&D; partition with half glass and batch dip workshop; and

(b) plant and machinery (P&M) in the factory, namely emergency stop switch; fire sprinkler system; effluent plant; upgrading of chromic acid plant; plant rewiring; fixtures and fittings; air conditioner; environmental air conditioner; former boxes; divert canteen discharge; sludge dryer and computer equipment.

The above are referred to as "Disputed Items".

Among the facts admitted or proved before the SCIT are the following:

- The Disputed Items play a necessary and integral role in the Taxpayer's business (proved by testimony of a witness for the Taxpayer).
- The Taxpayer incurred capital expenditure for the purposes of expansion and

modernization of its manufacturing activity.

- To ensure efficiency and to reduce wastage of raw material, every stage of the manufacturing process (4 in all) is recorded by entering all information into the "*Systems, Applications and Products in Data Processing Transaction System"* (SAP System) with the help of barcode scanning. This system helps to eliminate human errors caused by manual entries of records of all movements in each manufacturing stage and enables the Taxpayer to keep track of its manufacturing activity, thus ensuring efficiency.
- The Taxpayer incurred capital expenditure in its expansion and modernization of its factory (in the form of upgrading works) and the purchase of P&M.
- The Taxpayer's expansion and modernization was not done for cosmetic reasons (as testified by witness for the Taxpayer).
- Forms NL for YA 2001 and 2002 were raised after the 6-year limitation period which expired on 31.12.2007 and 31.12.2008 for YA 2001 and YA 2002 respectively. No reason was provided by the DGIR for the delay.
- The tax returns and Borang EPS for YA 2001 and YA2002 were submitted by the Taxpayer within the prescribed time frame for submission of returns. The Taxpayer had also given full cooperation and made full and frank disclosures to the DGIR at all material times.

The SCIT allowed the Taxpayer's appeal and held that:

(a) the DGIR had failed to discharge the burden of proof under S91(3) in respect of Forms NL for YA 2001 and 2002.

(b) the Taxpayer is entitled to claim RA under Sch. 7A for all the Disputed Items;

(c) it was not appropriate for the DGIR to impose penalties under S113(2) for YA 2003, 2004 and 2005.

The DGIR then appealed to the High Court (the Court).

The sole issue for determination of the Court is whether the Taxpayer is entitled to claim RA under Sch. 7A in respect of expenses for the SAP System amounting to RM1,375,930 for YA 2006.

Decision:

Appeal dismissed. The grounds of decision are summarized below:

1. **Submission by DGIR**

The DGIR submitted that the SCIT erred in law in respect of the SAP System. Among the reasons cited are the following:

(i) The meaning of paragraphs 1 and 8(a) of Sch. 7A is not the same as the meaning of Sch. 3. If Parliament had intended for RA in Sch. 7A to be governed by Sch. 3 it would have made its intention clear in Sch. 7A.

(ii) The Taxpayer had failed to prove that the SAP System qualified for the claim of RA under paragraph 1 and 8(a) of Sch. 7A as a "qualifying project", i.e. the SAP System is for the purpose of expanding, modernizing or automating the Taxpayer's existing business.

(iii) The SCIT had failed to consider the application of the clear and unambiguous words of the Proviso to Paragraph 1, (citing *National Land Finance Co-operative Society Ltd v DGIR* [1993] 4 CLJ 339)

(iv) The SAP System was not solely used for the manufacturing of the Taxpayer's products but also for other purposes, namely, it was –

- used to communicate with the Taxpayer's counterparts in other countries (i.e. for administration and management purposes);
- used for financial management and reporting (i.e. for accounting purposes);
- used by the taxpayer's directors, management team and administrative staff, both local and foreign (hence, the Proviso to paragraph 1 applies). This is proven by the Taxpayer's own contemporaneous documents.

2. **Provisions of the law and legal onus**

2.1 The relevant provisions of the ITA cited for deliberation are Section 133A *("Special incentive relief"*; Sch. 3 (*Capital Allowance And Charges*); Sch. 5 (*Appeals*) – Paragraph 13 (*Onus of proof*) and 34 (*Further appeals*); Sch. 7A (*Reinvestment Allowances*);

2.2 With regard to the party on which legal onus rests, the Court is of the view that –

(i) in a taxpayer's appeal to the SCIT, paragraph 13 of Sch. 5 clearly imposes the legal burden on the taxpayer (*Lower Perak Co-operative Housing Society Bhd v KPHDN* [1994] 2 MLJ 713)

(ii) Where the SCIT have made a Deciding Order (DO) and there is an appeal to the High Court on (a) question/s of law by way of a case stated, the appellant (whether the taxpayer or the DGIR) has the legal onus to satisfy the High Court that there should be judicial intervention by the High Court in respect of the DO. (*Lower Perak Co-op* case and *Kyros International Sdn Bhd v KPHDN* (2013) MSTC 30-056).

2.3 Based on *Kyros International Sdn Bhd* the DGIR and not the Taxpayer has the legal onus to satisfy the High Court that the part of the DO in respect of the SAP System should be set aside on any one or more of the following grounds:

(i) the SCIT had committed an error of law (viz. either the Taxpayer was not entitled to claim RA under Sch. 7A, para. 1 and 8(a) in respect of the SAP System, or the SCIT had failed to apply the Proviso to paragraph 1.)

(ii) the DO in respect of the SAP System could not be supported by the primary facts found by the SCIT; or

(iii) the SCIT's conclusion of mixed fact and law in respect of the SAP System was one which no reasonable SCIT could have reached if they had correctly directed themselves.

3. **Can the Taxpayer claim RA for SAP System?**

3.1 The Court took the following approach in arriving at the answer to the above question:

(i) Examination of decided cases;

(ii) Examination of conditions for claiming RA on the SAP System;

(iii) Consideration of how the ITA is to be interpreted.

3.2 *Decided cases* – the Court quoted from the Judgments of a number of decided cases relating to RA, most extensively from the following (with a sampling of the quotes that reflect important principles reproduced below):

(i) *KPHDN v Hicom-Suzuki Manufacturing Sdn Bhd.* [2012] 1 LNS 667

" ….*Sch. 7A is made pursuant to section 133A whereby is stated* "*Notwithstanding*

any other provision of this Act, special incentive relief shall be given in accordance with Sch. 7A. This must necessary (sic) mean that if for example a Sch. 3 allowance had been allowed it does not preclude a special incentive relief in the form of reinvestment allowance from being given provided it satisfies the criteria provided."

(ii) *KPHDN v Firgos (M) Sdn Bhd* (2013) MSTC 30-065

"...If Parliament had intended reinvestment allowance to be restricted only to "production area", then Parliament would have surely specified this clearly in Sch. 7A.."

(iii) *Penfabric Sdn Bhd v KPHDN* (2013) MSTC 30-069

"*Applying the cases in Yarmouth and Maden & Ireland Ltd. this court views that the Information Technology System is plant as the item/system is used by the Appellant for carrying on their business and ….it is kept for permanent employment in their business…..*

The project fulfills Sch. 7A 1(a), (b) and 8(a) of the same Sch. 7A…."

(iv) *KPHDN v OKA Concrete Industries Sdn Bhd* (2015) MSTC 30-091

" ….those items claimed by the respondent are necessary and integral to the respondent's manufacturing activity, based on the functionality test, that every of such items performs an integral function in the context of the respondent's business of manufacturing ready mixed concrete and precast concrete products."

3.3 *Conditions for claiming RA –*

(i) The Court's view regarding S133A is that special relief incentive "*shall be given in accordance with Sch. 7A* " notwithstanding any other provisions in the ITA. As such the meaning of Sch. 7A cannot be confined by any provision in the ITA, including Sch. 3 (based on *Hicom-Suzuki Manufacturing*).

(ii) The conditions for claiming RA are set out in paragraphs 1 and 8 of Sch. 7A. It is not disputed that the Taxpayer has satisfied the conditions (in paragraph 1) in that it was resident in Malaysia, and had been in operation for not less than 12 months.

3.4 *How to interpret the ITA?*

The Court reviewed the principles of interpreting statutes established in precedent cases, and concluded by quoting from the case of *Palm Oil Research and Development Board Malaysia & Anor v Premium Vegetable Oils Sdn Bhd* [2004] 2 CLJ 265 –

"…..S17A of the Interpretation Acts 1948 and 1967 neatly fits into and is complimentary with the third principle in the judgment of Lord Donovan. Hence, the governing principle is this. When construing a taxing or other statute, the sole function of the court is to discover the true intention of Parliament. In that process, the court is under a duty to adopt an approach that produces neither injustice nor absurdity: in other words, an approach that promotes the purpose or object underlying the particular statute albeit that such purpose or object is not expressly set out therein…."

3.5 *Has the Taxpayer incurred capital expenditure regarding SAP System under paragraphs 1 and 8(a) of Sch. 7A?*

(i) Based on S17A of the Interpretation Acts 1948 and 1967 and the Federal Court's judgment in the *Palm Oil Research & Development Board* case, S133A, paragraphs 1 and 8(a) of Sch. 7A should be given a purposive interpretation:

"I am of the view that the purpose of s 133A, and paragraphs 1 and 8(a) of Sch. 7A is to provide a "special incentive relief" to companies resident in Malaysia which have been in operation for not less than 12 months, to invest in the expansion, modernization or automation of their product manufacturing or processing."

(ii) The SCIT had made the following findings of fact:

- The Disputed items, including the SAP System play a necessary and integral role in the Taxpayer's business.
- The Taxpayer had incurred capital expenditure for the purpose of expansion and modernization of its manufacturing activity.
- The function of the SAP System enables the Taxpayer to keep track of its manufacturing activity and ensures efficiency of the same.
- The Taxpayer's expansion and modernization was in the form of upgrading works to the factory and was not done for cosmetic reasons.

(iii) Based on the above findings of fact by the SCIT, the Court is satisfied that the purpose of S133A read with paragraphs 1 and 8(a) of Sch. 7A has been satisfied with regard to capital expenditure on the SAP System.

(iv) A purposive construction of the provisions stated above does not take into account the DGIR's contention that the SAP System –

- is not solely used for manufacturing the products of the Taxpayer, but is also used for management, administration and accounting purposes.
- is not directly involved in the manufacture of rubber gloves, and
- is not located in the production area of the factory.

(v) Alternatively, the Taxpayer's capital expenditure on the SAP System has satisfied a literal interpretation of the relevant provisions, for the following reasons:

- The Taxpayer had incurred capital expenditure on the SAP System in the basis period for the YA in question, and it was incurred "on a factory" used in Malaysia (both requirements under paragraph 1(b) Sch. 7A);
- The Taxpayer had undertaken a project in the factory to expand and modernize "*its existing business* (of manufacturing rubber gloves) *within the same industry*" as understood in the meaning of "*qualifying project*" found in paragraph 8(a) of Sch. 7A. Such a project clearly included the SAP System.
- The capital expenditure on the SAP System was incurred for the purpose of the "qualifying project" as envisaged in paragraph 1(b) of Sch. 7A.

(vi) A literal construction of paragraphs 1 and 8(a) of Sch. 7A does not require the fulfillment of matters contended by the DGIR in paragraph 3.5(iv) above.

(vii) A purposive or literal interpretation of paragraphs 1 and 8(a) of Sch. 7A should be adopted unless there is evidence that the Taxpayer had intended to evade tax by any of the ways stipulated in S140(1)(a) to (d) of the ITA. However, no evidence had been adduced by the DGIR before the SCIT of such an intention on the taxpayer's part in claiming RA on the SAP System, and there was no such finding of fact by the SCIT.

4. Does Proviso to Paragraph 1 apply?

4.1 The purpose of the Proviso to paragraph 1 is to disallow RA when *"capital expenditure is incurred on P&M which is provided wholly or partly for the use of a director, or an individual who is a member of the management, or administrative or clerical staff"*.

(i) In the Court's view, (adopting a purposive interpretation) this Proviso does not apply when the purpose of the capital expenditure is for the use of a taxpayer's "*factory" "for the purpose of a qualifying projec*t".

(ii) The SCIT did not make any finding of fact that the words of the Proviso (quoted above under 4.1) could be applied to capital expenditure on the SAP System. On the contrary, they made a finding of fact that the Disputed Items (including the SAP System) play a "*necessary and integral role*" in the Taxpayer's business. Therefore the Proviso to paragraph 1 cannot apply.

4.2 The Court referred to the decisions of the apex courts in the following cases:

(i) *Garden City Development Bhd v Collector of Land Revenue, Federal Territory* [1982] 2 MLJ 98

(ii) *R Rama Chandran v The Industrial Court of Malaysia & Anor* [1997] 4 MLJ 145

Based on the above cases, the Court concluded that (the general purpose of) *"a proviso is to relax the full rigour of the main statutory provision and cannot be construed so widely so as to render redundant the main statutory provision*". If the Court were to accede to the DGIR's submission that the Proviso applies (see paragraph 1(iv) above) it "*will be giving effect to that Proviso which will undermine, if not defeat, the purpose of paragraph 1 of Sch. 7A*."

4.3 Alternatively, based on a literal interpretation, the words of the Proviso (quoted in paragraph 4.1 above) does not apply to capital expenditure on the SAP System as the System plays "*a necessary and integral role*" in the Taxpayer's business (a fact found by the SCIT).

Members may read the full Grounds of Judgment at the Institute website and the LHDNM website.