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TECHNICAL

TAX CASE UPDATE

Payments by timber contractor to the holder of Forest Timber Licence – whether capital or revenue expenditure

PIRAMID INTAN SDN BHD. v. KPHDN (2014) (High Court in Sabah and Sarawak) (Appeal No: KCH-14-1/8-2012)

Date of Judgment: 20 October 2014

Facts:

The appellant (the taxpayer) was incorporated in 1992 and commenced business in 2000. It carried on the business of purchase and sale of timber. As the taxpayer did not have a timber licence, it bought timber from other Forest Timber Licensees, one of which is Sarawak Timber Industries Corporation (STIDC). On 19.8.2002, the taxpayer entered into an agreement with STIDC for the sale and purchase of timber logs, including the extraction of such logs. Among the terms of the agreement are the following:

1. The taxpayer would pay the sum to RM 40 million to STIDC. Of this sum, RM 10 million was to be paid upon signing of the agreement, with another payment of RM 10 million one month from the date of the agreement. The balance of RM 20 million was to be paid progressively by monthly premium of RM 85,000 or RM30 per cubic meter of merchantable logs actually harvested, whichever is higher, until fully paid up.
2. STIDC is the holder of the Forest Timber Licence for the designated concession area under the agreement, while the taxpayer is the timber contractor.
3. The taxpayer shall pay royalties and premium to STIDC based on the total timber logs extracted.
4. The contract period is 20 years, from 19.8.2002 to 18.8.2022.

Pursuant to the contract, the taxpayer made payments to STIDC for the years of assessment (YA) 2003 and 2004, which were not allowed to be deducted from gross income by the DGIR. The DGIR raised assessments for these years and also imposed penalty for the relevant YA in the amounts shown below:

YA	Amount paid to STIDC (RM)	Tax Payable (RM)	Penalty(RM)
2003	21,040,747.00	2,588,221.00	803,241.00
2004	680,000.00	5,155,935.23	1,600,117.83

The taxpayer appealed to the Special Commissioners of Income Tax (SCIT) against the assessments for YA 2003 and 2004.

Rationale and Deciding Order of SCIT

The SCIT ruled in their Deciding Order that:

1. The SCIT is*"…of the opinion that an expenditure which relates to the acquisition of a source of income or capital asset would be of a capital nature, whereas expenditure relating to the performance of profit earning operations would be of a revenue in nature." "The letter and the*

agreement reflect that the upfront payment of RM20,000,000 has no relation with the cost or logging activity from the concession area but it is more of a consideration from the appellant upon being appointed as the contractor to obtain the right to extract, remove and sell timber logs from STIDC's concession area."

Hence the payments to STIDC in each relevant year of assessment (as shown above) should not be allowed as a deduction in the computation of taxable income for YA 2003 and 2004;

2. the penalty imposed on the taxpayer pursuant to S113(2) of the Income Tax Act 1967 (ITA) should not be imposed as the facts of the case showed that the taxpayer did not reduce or failed to report its income, but merely made a technical adjustment due to a difference in interpretation only.

The taxpayer then appealed to the High Court against the first ruling, while the DGIR cross appealed against the second ruling.

Issues before the High Court

The issues for determination are:

1. In the taxpayer's appeal – whether the amounts of RM 21,040,747 and RM680,000 paid to STIDC for the YA 2003 and 2004 respectively should be allowed as a deduction in the computation of taxable income of the taxpayer in each respective YA, or be allowed to be deducted over the period of the agreement by reference to the quantity of timber extracted.

   Revenue's submission

   "*The appellant is in the business of extracting, buying and selling timber logs thus its stock in trade is timber logs and standing timber; the concession area is large approximately 84,234 hectares for a period of 20 years; the payment of RM40 million and especially the upfront payment of RM20 million was a more of a consideration for the appellant to obtain the right to extract, remove and sell timber logs from the concession area*." Hence, the payments were capital expenditure

   Even if they were not considered as capital payments, they were not incurred in the basis period in which the related income was produced and as such had not fulfilled the basic requirements in S.33(1) of the ITA and not allowable as deductions.

   Appellant's submissions

   The payments did not result in the appellant "*acquiring any right to the standing timber or any right to the Land.*" They were made "*to secure an exclusive right to fell, extract and purchase timbers from STIDC, without which the appellant would have loss (sic) one of its sources of income*." They were "*upfront payments of the costs of production of timber logs*" "*similar in character to the payment made by the taxpayer in the case of DGIR v. Hup Cheong Timber (Labis) Sdn Bhd [1985] 2 MLJ 322*."

   The appellant contended that "*there needs to be no direct link between every ringgit spent with every ringgit of revenue generated before the expense can be deducted, it would be sufficient that the payment is made in the course of gaining or producing income.*" It was submitted that "*even if there was no actual production of timbers or no generation of income, so long as the expenses were incurred wholly and exclusively by the appellant for the production of gross income for the years of assessment they were deductible under s.33(1) ITA.*" It was further submitted that "*the respondent agreed …..that the payments made were deductible but the quantum of the deduction is limited to the actual quantity of timbers produced. If there are premiums which are not allowed to be deducted, it may be allowed in the future when there is timbers produced based on the quantity of timbers produced at the relevant years. Therefore, the respondent should not be allowed to approbate and reprobate*."

2. In the DGIR's cross appeal – whether the SCIT's decision that the penalty imposed under

S113(2) should not be imposed, is correct.

Appellant's submissions

The appellant submitted that it did not give any incorrect information to the respondent. The reduction was merely a result of a technical adjustment due to a differing interpretation of the tax legislation by the respondent.

Revenue's submission

The Revenue submitted that "*on the factual matrix there was a failure by the appellant to submit correct information regarding the nature of the payments made under the Agreement*." As such "*it was right in law to impose a penalty under s.113(2) ITA in respect of the tax undercharged* " and "*a correct exercise of discretion by the respondent to impose a penalty of 45% as under the law a maximum of 100% could have been imposed*…" It is also contended that good faith is not a defence against the imposition of penalty.

Decision:

The appeals by the taxpayer and the DGIR were both dismissed. The Deciding Order of the SCIT was affirmed.

The grounds of decision are summarized below:

1. The Court drew attention to the following factors:
   a) Both the taxpayer and the DGIR did not dispute the facts as found by the DGIR. Guidance is derived from the cases of *Edwards v Bairstow and Harrison* [1955] 3 all R.R. 48(HL) and *Chua Lip Kong v DGIR* [1982] 1 MLJ 235 (PC). "*The gist of both cases is this. The finding of primary facts by the Special Commissioners are not assailable. They cannot be overruled or supplanted by the High Court. If the facts are insufficient for the Court to decide the question of law raised by the Case Stated then it would be necessary to remit the case to the Commissioners for further findings*."
   b) The burden of proof lies with the appellant (taxpayer in this case) and the standard of proof is on the balance of probabilities. However, in the present case where both parties had appealed, it cannot be correct to say that only the appellant had the onus to show that the assessment is wrong. The onus is on the respondent (DGIR) to show that the SCIT was wrong on the penalty.
2. Capital expenditure is not defined in the ITA. For aid in this matter, reference was made to case laws and dictionaries, some of which shown below: (The points which are salient in the definitions are highlighted in the quotes next to the source.)

Source	Definition
Words, Phrases & Maxims on Capital and Revenue Expenditure	"When an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade….(it) must properly be attributed…to capital. But when…incurred for the maintenance and preservation of an existing asset…(it is) an income or revenue expenditure."
Webster Encyclopedic Dictionary of the English Language	"money spent on improvement or additions."
KH Alyers Judicial Dictionary 14th Edition	"Capital expenses….(is) made by a business to provide a long term benefit;…..(but) if…..made…for running the business or working it with a view to produce the profits it is a revenue expenditure."
Vallambrosa Rubber	"….capital expenditure is that (which) is going to be spent once and

Co. Ltd. V Farmer 5 TC 529	for all, and income expenditure is a thing that is going to recur every year."
DGIR v Hup Cheong Timber (Labis) Sdn Bhd. [1985] C;J 107	"The payments were not done to acquire an interest on the land or the purchase of standing timber or the acquisition of land with the right to extract the timber on it. These payments were made for the extraction of timber. We are of the view that the payments were revenue in nature."

3. To be deductible, a payment must be authorized as a deduction by S33(1) and not be disallowed by S39 (*DGIR v LTS* [1985] 1 BLJ 166). Deductible expenses can only refer to revenue expenses (*Kanowit Timber Sdn Bhd v KPHDN* [2008] 6 C;J 542).

4. The SCIT had held that the RM20 million upfront payment to STIDC was paid to obtain the right to extract, remove and sell timber logs from STIDC's concession area, and therefore had the effect of bringing into existence an advantage for the enduring benefit of the taxpayer's trade. Also, all premium and royalty from October 2002 to August 2004 were not allowable as there was no production of timber logs for that period. The High Court agreed that the "upfront payments" were not wholly and exclusively incurred in the production of gross income for YA 2003 and 2004. Thus the appellant had not justified the expenditure incurred as being deductible under S33(1).

5. The Court did not agree with appellant's contention that the payments were revenue expenditure as it was not consistent with the findings of the SCIT that STIDC is the licence holder; the timber concession is 84,234 hectares, the agreement is for a period of 20 years and there were upfront payments. The case of DGIR v Hup Cheong Timber is distinguished in that the appellant in that case, Hup Cheong Timber, was the licence holder.

6. On the penalty imposed under S113(2), the Court highlighted the SCIT's statement that they (SCIT) had arrived at their finding after "having heard the facts, the evidence adduced and the submission of both parties and having read the documentary exhibits tendered…." The High Court had "*deduced with certainty that the SCIT had found as facts that the appellant did not understate or omit their income but merely it was a technical adjustment due to a differing interpretation*". The SCIT would have taken into account the fact that there was full disclosure of information to the DGIR, and there was no deliberate submission of incorrect tax return and information.

7. According to one of the witnesses called, Revenue had itself agreed that the payments that were not allowed as deductions would be allowed at a later date when timbers were in production. This would certainly constitute "differing interpretation" and the taxpayer's interpretation that the payments were revenue expenditure cannot be viewed as "escaping from paying tax." The case of *Syarikat Ibraco-Paremba Sdn Bhd v KPHDN* was distinguished as the facts as found by the SCIT in that case showed that there was tax avoidance when the taxpayer entered into transactions through shell companies, that altered the tax position.

8. The Court was of the view that the SCIT came to the right conclusion that the DGIR, in exercising the discretion (to impose penalty or not) had not given due consideration to all relevant facts and circumstances. Therefore the SCIT's decision in not imposing the penalty is correct in law.

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