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Direct Taxation

TAX CASE UPDATE

DEDUCTIBLE EXPENSES UNDER SECTION 33(1) OF THE INCOME TAX ACT 1967 (ITA)

ENSCO GERUDI (M) SDN BHD v KPHDN

High Court of Malaya at Kuala Lumpur
Civil Appeal No: 14-11-08-2014
Date of Judgment: 11 June 2016

Facts and Issues:

This is an appeal against the decision of the Special Commissioners of Income Tax (SCIT) in dismissing the appellant's appeal against additional assessments raised by the respondent (KPHDN) for the year of assessment (YA) 2006.

The appellant is a company incorporated under the Companies Act 1965 in 1994, which carries on a business of providing offshore drilling services to the petroleum industry in Malaysian territorial waters. In November 2005, the appellant entered into a contract with an unrelated party, Carigali-Triton Operating Co. Sdn Bhd (CTOC) for the provision of one "Jack-up Drilling Rig" to CTOC, which was identified as "ENSCO 104" ("Rig"). The Rig is a vessel flagged in Liberia and built in 2002 in Singapore. The appellant leased the Rig from ENSCO Offshore International Company (ENSCO Offshore), owner of the Rig under a Standard Bareboat Charter (SBC) dated 5.4.2006. However, the SBC was terminated on 20.9.2006. The appellant then entered into a Master Bareboat Charter (MBC) dated 21.9.2006 with ENSCO Labuan Ltd. (ENSCO Labuan) which resulted in the appellant leasing the Rig from ENSCO Labuan instead of ENSCO Offshore. ENSCO Labuan leased the Rig from ENSCO Offshore and then let it out to the appellant.

The following expenses incurred by the recipient were disallowed by Revenue, and were held to be not deductible under S33(1) of the ITA by the SCIT:

	Item	Amount (RM)
(a)	Scheduled Repair Accounts (SRA)	1,075,402
(b)	Underwater Inspection In Lieu of Dry Dock (UWILD expenditure)	250,783
(c)	Other Direct Cost	18,929

In carrying out its business of leasing rigs from owners, the appellant took possession of the rigs it leased on a "as is where is" basis (under a bareboat charter). Maintenance of the rig was borne by the charterer or lessee and not the rig owner or lessor. Maintenance (item (a)) was pre-planned (tracked by a computer program), and parts required for maintenance would have to be booked in advance. For major maintenance an Authorization for Expenditure (AFE) would be raised. To purchase replacement parts, the local ENSCO entities in the countries in which the vendors were located would first make the necessary payments. It would then be charged-back to the beneficiaries of the part (in this case, the appellant) through intercompany invoices. As expenditures for the Rig could ultimately be traced back to the CTOC contract for the benefit of the appellant, the expenses were ultimately borne by the appellant.

UWILD expenditure (item (b)) was a periodic expenditure incurred twice every 5 years under a mandatory requirement imposed by the American Bureau of Shipping (ABS) to periodically certify the operational efficiency of the Rig. The Lease provided that the appellant was responsible for maintenance and upkeep of the Rig including the UWILD expenditure. The cost would be first borne by the Rig owner, and subsequently redistributed to the relevant ENSCO entity which used the Rig within a prescribed period of 24 months. In this case, the charge-back to the appellant had occurred in YA 2006. The appellant was contractually obliged to make these payments.

Not all parts of the rig could be kept on board the Rig while it was in operation in Malaysian waters, and therefore the appellant had to provide an operationally suitable storage yard in Malaysia for the parts. To ensure proper storage of parts for the CTOC contract, the appellant incurred expenses on a rented yard in Kemaman (item (c)).

In the appeal before the SCIT, it was held that:

- the 3 items of expenditure referred to above were not deductible under S33(1) of the ITA, and
- penalty imposed for the YA 2006 was properly imposed.

Hence, this appeal against the decision of the SCIT. The question for the opinion of the High Court (the Court) is whether, on the facts as found by the SCIT, the decision of the SCIT was correct in law.

Decision:

Appeal allowed. The grounds of decision are summarized below:

1. After reviewing the decisions in a number of precedent cases and the principles established in these cases, the Court summed up the law as follows:

   "*By virtue of the preceding authorities which I have discussed, it is clear that for the Appellant to obtain a deduction for expenses made, it must satisfy the following elements:*
   (a) outgoings and expenses;
   (b) wholly and exclusively;
   (c) incurred during that period; and
   (d) in the production of income.
   ……..."

2. *Scheduled Repair Accounts*

   The respondent contended that the expenses were incurred before the SBC commenced, which said Charter the respondent recognized as the primary document to be given effect to, not the CTOC agreement. The SCIT rejected the claim for these expenses as they had found that "*on the date that the CTOC contract was signed, the appellant was not yet in possession of ENSCO Rig 104 in Malaysian territorial waters to be engaged in activities and providing services to its customer (CTOC).*" They agreed with the respondent's argument that the expenses were incurred before the Rig entered Malaysian waters and hence, before the coming into effect of the SBC. However, the Court was of the view that the SCIT had erred in the following manner:

   2.1 It is important to bear in mind the nature of the appellant's business. The "disputed AFEs" authorizing the disallowed expenses were approved in advance on 22.11.2005, 17.1.2006 and 20.3.2006 with a future looking scheduled start date consistent with the estimated start date for the CTOC contract (evidenced by documents submitted). The AFEs were authorization orders for specialized replacement parts to be placed in advance of planned use. These expenses were incurred by the appellant when they were charged back by the Ensco entities that made the purchases on its behalf. These costs were charged to the SRA in YA 2006. It could be seen from the Ledger entries running from 30.4.2006 till 28.8.2006 that the majority of the expenses took place after the lease took effect on

5.4.2006. These were facts found by the SCIT (supported by documentary evidence). However, the SCIT's finding that "*upon sailing into Malaysian waters on 12.4.2006, ENSCO Rig 104 did not undertake any further repairs or maintenance work in any Malaysian port….*" was, in the Court's view, inaccurate, as neither the appellant nor the respondent averred that no further works were done when the Rig sailed into Malaysia after 12.4.2006.

2.2 Further, there was "unchallenged evidence before the SCIT" which contradicted the above finding of the SCIT. (The Judge then went on to make mention of the documents submitted and oral evidence which contradicted the finding of the SCIT.) In the light of the proved facts of the nature of the pre-planned maintenance and the requirement for AFEs to be accordingly issued as part of the appellant's planning process, the Judge took the view that the schedule dates and the estimated completion dates in the AFEs did not denote the actual date that the maintenance was due.

2.3 The SCIT, in focusing on the point that the appellant must have physical possession of the Rig before there can be any generation of income from operating it (provide services to CTOC), has erred by ignoring the unique aspect of the AFEs and the fact AFEs are issued and parts are booked in advance by virtue of the pre-planned maintenance required throughout the operation of the Rig. To counter the first mentioned point, the following analogies were posed:

- a lawyer denied deduction for expenses already incurred in the purchase of paper wholly and exclusively for the purpose of a single identifiable litigation, because he has not yet received physical possession of the paper;
- a contractor not allowed to deduct expenses incurred on the purchase of cement exclusive for the purpose of a single, identifiable project, because he has not yet received physical possession of the cement.

3. *UWILD Expenses*

The respondent had also submitted that the expenses were incurred prior to the effective date of the SBC (5.4.2006), and were correctly added back as they were incurred in YA 2005 and not YA 2006. The SCIT stated (in the Case Stated) that "*from the facts of the case, we understand that the UWILD expenditure was made in the years (sic) 2005 for a certification inspection conducted outside Malaysia…"* The SCIT held that the expenses were not allowable under S33(1) of the ITA, because they were "*incurred prior to the tax year under appeal*" and the issue relating to the fact that the expenditure was a 'charged-back amount' is "*irrelevant for* (the SCIT's) *consideration and due determination*." However, the Court was of the view that the SCIT had erred in their findings for the following reasons:

3.1 It is important to bear in mind the objective of the UWILD expenses and the ENSCO's group policy of distribution of expense account over a period of 24 months and allocate the monthly cost to whichever ENSCO entity was using the particular rig. The appellant had correctly submitted that the deduction for expenses claimed was simply its share in proportion to the time period in which the ENSCO 104 was used in YA 2006 for the CTOC contract, and adduced evidence in the ledger (which recorded these transactions).

3.2 The case of *ME Holding Sdn Bhd v KPHDN* (2011) MSTC 10-013 was referred to, wherein the SCIT said that accounting and legal principles recognized that expenses should be matched (i.e. deducted) against corresponding income, provided that there is a legal obligation to pay the expenses, and the expenditure is sufficiently accurate. Therefore the question to ask is whether the expenditure is sufficiently accurate, or capable of reasonable estimate. The Court noted that the SCIT had repeatedly referred to "other evidence" that they had relied upon which makes the accounts/ledger of the appellant not

acceptable (to the SCIT) but the Court could not see what these 'other evidence(s)' were, and concluded there were none. Hence, the finding of the SCIT of not allowing the appellant's UWILD expenses was "misconceived".

4. *Kemaman Rented Yard*

The SCIT dismissed the claim for the above expenses on the grounds (amongst others) that they were capital in nature, and certain of the works done constituted improvements rather than repairs. However, the Court gave its own view as stated below:

4.1 The correct approach to address whether the expense is capital in nature is to ask –
(a) whether or not there is an identifiable asset; and
(b) whether or not an asset was brought into existence or an advantage was granted for the enduring advantage of the trade.

The above conforms to the "Atherton test" in *British Insulated and Helsby Cables v Atherton* [1928] AC 205, under which an expense qualifies as capital if it is found that there is an intention of creating an asset, or there is brought into existence an advantage for the enduring benefit of the trade.

4.2 Having regard to the evidence of the appellant's witness (AW-1), the intention of the appellant with regard to the rented yard was clear. It was needed only for as long as there were rigs available in Malaysia. If there was none, the yard would not be needed, and there was no associated long term plans to the yard, whilst the duration of the CTOC contract was only 1 year (according to AW-1). The only reasonable conclusion that could be reached was that there was no intention to create profit making apparatus assets from the expenditure for the Kemaman rented yard.

5. *Penalty imposition*

In upholding the penalty imposed by the respondent, the SCIT agreed that the appellant had filed an incorrect return for YA 2006. The respondent had submitted that the under S113(2) of the ITA, the respondent has power to impose a penalty equal to the amount undercharged due to incorrect return made.

5.1 The Court noted that while the respondent is conferred the discretion to impose penalty, the Supreme Court had held, in the case of *KPHDN v. Kim Thye & Co.* [1992] 2 MLJ 708, that "*this provision does not vest unfettered discretion in the Revenue Board to be exercised at whim and fancy*." The question then, is whether the respondent had exercised its discretion properly according to the facts and circumstances of this case.

5.2 The Court could not agree with the respondent's submission that the incorrect return was intentional, but held the view that the appellant did not attempt to evade or avoid tax nor to conceal any evidence but had made full and frank disclosure and given its full co-operation to the respondent during the tax audit. In fact, at all material times, the appellant had sought professional advice in the discharge of the burden of showing that the assessment should not have been made. "*It cannot be the intention of Parliament to punish taxpayers who innocently submit incorrect tax returns or those taxpayers who engage professional tax agents to prepare and submit their tax returns*." (quoting from the case of *Office Park Development Sdn Bhd v. KPHDN* [2011] 9 MLJ 479,)

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