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TECHNICAL

Direct Taxation

TAX CASE UPDATE

Claim for Reinvestment Allowance on New Factory Building.

KPHDN v NULOGITEC INDUSTRIES SDN BHD

High Court of Malaya at Georgetown, Penang
Civil Appeal No: No. 14-4-12/2015
Date of Judgment: 21 July 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) made in a Deciding Order dated 4/9/2015, in which it was held that –

i. the claim by the respondent (NISB) for Reinvestment allowance (RA) for the years of assessment 2006, 2007, 2008 and 2010 in respect of the following assets should be allowed:
   (a) Fire fighting system
   (b) Factory building
ii. it was inappropriate for the DGIR to impose penalty under S113(2) of the Income Tax Act (ITA) 1967

(All sections cited hereinafter refer to sections in the ITA unless otherwise stated.)

The question of law for the High Court ("the Court") to decide was whether on the facts as stated by the SCIT, their decision is correct in law.

The following are the relevant facts:

i. NISB is a private company incorporated under the Companies Act 1965. Its principal activity is the manufacture and supply of different types of sizes of PVC pipes to customers, based on customers' specifications.
ii. NISB first carried on its business in a rented factory (since 1/4/1998) with a built up area of 24,000 square feet, which housed 4 machines used in the manufacturing process. Its raw materials and finished goods were kept in the open space in the factory. In 2004, NISB acquired a new factory and relocated its business operations to the new factory, which has a built up area of 37,500 square feet. The 4 machines at the old factory were relocated to the new factory albeit one of them was modified to produce scrap for pallet. A new machine was acquired in 2004, hence 5 machines were in operation in the new factory.
iii. NISB claimed RA on the new factory as being used for expansion of its business for the YA 2005. But for YA 2009 and 2010, it claimed RA on the same factory on the basis of modernization and automation of its business. During the years of assessment 2004 to 2010, NISB only used 4 of its machines in its production activities.
iv. There was no increase in NISB's production and sales for the relevant YAs.

Decision:

The Court held that the SCIT did not err in law in their decision that NISB is entitled to RA as claimed. Consequently, their decision in allowing NISB's appeal on the penalty imposed by the DGIR is correct, and there is no error of law here as well.

The grounds of decision are summarized below:

1. The DGIR contended that the SCIT had erred by focusing on whether NISB's new factory constituted a factory rather than a qualifying project within the contemplation of the ITA, and submitted that it is necessary to adopt a two-tier analysis as to whether that factory was reinvestment instead of an initial investment based on Public Ruling no. 2/2008, and thereafter, whether that factory is an expansion, modernization or automation in respect of manufacturing or processing of a product.
2. With regard to the issue of the role of the High Court in dealing with a case stated (CS) by the SCIT, the Judge referred to the case of *Lower Perak Co-operative Housing Society v. KPHDN [1994] 2 MLJ 713*, and drew the following conclusion:

   "In brevity and as submitted by the DGIT (DGIR), *the high court may intervene on the following grounds:*
   - *(i) there is a misconception of law;*
   - *(ii) the conclusion of law cannot be supported by the primary facts; or*
   - *(iii) the conclusion of mixed fact and law that no reasonable special commissioner could have reached if they have correctly directed themselves."*
3. In addressing the contention of the DGIR in (1) above the Judge referred to the findings of the SCIT relating to the meaning of "factory" as stated in the CS. After an extensive review of the principles of interpretation of statutes as enunciated in various legal precedents, the Judge declared –

   "In *my view, the DGIT (DGIR) is not wrong in pointing out that the Special Commissioners have concentrated on whether NISB's new factory is a factory within the statutory framework….This is necessary because para. 1(b) of Schedule 7A of the ITA on entitlement to RA expressly stipulated capital expenditure incurred by the taxpayer on a factory for the purpose of a qualifying project. I do not therefore think the Special Commissioners have overemphasized that point in reaching their decision*."
4. On the SCIT's findings relating to the meaning of "factory", the Judge was "*of the view that the (SCIT) have correctly referred to and relied on the decision of the High Court in KPHDN v Success Electronics and Transformer Manufacturer Sdn Bhd KLHC Rayuan sivil no. R1-14-14/09 (unreported) (referred to as the SETMSB in the Case Stated)*…" and went on to quote (with apparent approval) excerpts from the Judgment in that case, including the following pronouncements:

   "…..Based on the above definitions of 'factory' and 'building', we are of the view that a factory is a building that is used to manufacture goods which may contain area for production and non-production,"

   "….The ITA has defined factory in Schedule 3, but not in Schedule 7A para. (1b). The learned (SCIT) had derived great assistance on the meaning to be assigned to that word from a distillation of a number of decisions in cases in which the courts had been faced with the task of deciding what a factory ought to include, rather than falling back on to the narrow meaning assigned to that word by an ordinary dictionary. The functionality of the claimed items in the overall context of the production in the manufacturing process ought to have been taken as a valid factor to be considered in giving the appropriate meaning to the word 'factory'. The (SCIT) were justified……to regard the non-production area as part

of the factory in both buildings for which the Taxpayer had incurred capital expenses.…I do not think that the learned (SCIT) had fallen into any error in so deciding."

5. On the DGIR's contention that the factory must be a reinvestment and not an initial investment (which is based on para 7.2.5 of PR No. 2/2008 dated 3/4/2008), the Judge noted that the SCIT had dismissed the contention as they held that the PR referred to is void by reason of inconsistency with paras. 1 and 8(a) of Sched. 7A as interpreted in the SETMSB case. However, he then referred to the Interpretation Acts 1948 and 1967, and pronounced that "*PR No. 2/2008 is not void pursuant to S23 (1A) of the Interpretation Acts 1948 and 1967, contrary to the position held by the Special Commissioners.*"
6. Nevertheless, the Judge also took note that PR No. 2/2008 was effective for YA 2008 and subsequent years of assessment, and reading that together with S20 (and its proviso) of the Interpretation Acts 1948 and 1967, he held that PR no. 2/2008 was inapplicable to NISB's claim for the new factory in Bukit Kayu Hitam that was acquired/ purchased in 2004.
7. Acknowledging that the DGIR was correct in pointing out that NISB's purchase of the new factory in 2004 was a "first investment in a factory building" (not a reinvestment), the Judge declared that after carefully reviewing the express provision in para. 8(a) of Sched. 7A, he found that "*the operative if not also governing words*" are "***its existing business***."

   "*Thus it is plain to me that the reinvestment must be in the existing business and not the existing factory ….**otherwise** that would be a strained interpretation of statute that was not contemplated by parliament. On the facts herein, NISB has already invested in the business of manufacturing PVC pipes since 1998 by operating in a rented factory in Jabi. Thus, the investment in a new factory in Bukit Kayu Hitam is plainly a reinvestment in the existing business*."
8. On the SCIT's finding that NISB had satisfied the element of automation as well as the components of modernization and expansion (relating to the meaning of "qualifying project" in para. 8(a) of Sched. 7A), the Judge commented that this is largely a question of fact and does not warrant intervention by the High Court.
9. He went on to address the DGIR's contention that there was no evidence to support the SCIT's findings on modernization and expansion, since sales or revenue of NISB did not rise, but plummeted instead, after acquisition of the new factory. Based on the Judge's careful review of the relevant provisions, there was not found "*any express stipulation of the need for proof of increased sales or revenue post the reinvestment*."

   "*On the facts herein, it is plain that the (SCIT) have correctly found there was expansion by reason of the larger size of the factory to house the manufactured products based on the definition of factory as held by the High Court in (the SETMSB case) and KPHDN v Firgos (M) Sdn Bhd [2014] 1 MLJ 701……**Besides** expansion, I am also of the view that it is justified for the (SCIT) herein to hold that there was modernization too by reason that the factory at Bukit Kayu Hitam acquired by NISB was a new one."*
10. In consequence of the above findings, the decision of the SCIT in allowing NISB's appeal on the penalty imposed by the DGIR is correct.

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