CHARTERED TAX INSTITUTE OF MALAYSIA

# e-CIRCULAR TO MEMBERS

**CHARTERED TAX INSTITUTE OF MALAYSIA (225750-T)**

**e-CTIM TECH 153/2013** **20 December 2013**

**TO ALL MEMBERS**

**TECHNICAL**

## Direct Taxation

## TAX CASE UPDATE

**Claim for Reinvestment Allowance and Penalty Imposed Under Section 113(2), ITA**

***Ketua Pengarah Hasil Dalam Negeri v Firgos (Malaysia) Sdn Bhd* (2013) [High Court]**
**(Civil Appeal No: R2-14-9-09/2012)**

**Facts:**

Firgos (Malaysia) Bhd (the Respondent) had claimed reinvestment allowance (RA) for the years of assessment 2005 and 2007 in respect of expenditure on the following items ("the Disputed items"):

i) Plant and machinery (Fire-fighting equipment and electrical fittings)
ii) Factory
iii) Cost of site preparation for installation of plant in the factory

The Director General of Inland Revenue (the Appellant) disallowed the claim in respect of the following:

i) The whole capital expenditure on fire-fighting equipment and 72.7% of expenditure on electrical fittings (on the basis that 72.7% of the factory is warehouse space)
ii) 72.7% of factory (warehouse space)
iii) The whole capital expenditure on site preparation for installation of plant

The Appellant had informed the Respondent that the "production area" which qualified for RA was 27.3 % (corresponding to the percentage of capital expenditure allowed on electrical fittings and factory). The claim for RA for fire-fighting equipment was disregarded, while expenditure on site preparation for installation of plant (the Respondent was informed) is not eligible for RA under Schedule 7A of the Income Tax Act 1967 (ITA). Consequently, the Appellant raised additional assessments for the years of assessment 2005 and 2007 with penalties imposed under Section 113(2) ITA.

The Respondent then appealed to the Special Commissioners of Income Tax (SCIT), who allowed the Respondent's claim in relation to the Disputed items and held that penalty imposed for the year of assessment 2007 was not appropriate ("tidak wajar"). The Appellant appeals to the High Court.

**Issues:**

i) Whether the Disputed items qualified for RA under ITA, as claimed by the Respondent for the years of assessment 2005 and 2007.
ii) Whether the Appellant exercised its discretion properly and lawfully in imposing penalty under Section 113(2) of the ITA in the year of assessment 2007.

**Decision:**

It was held, by Dato' Zaleha Binti Yusof J, that:

- The principle enunciated in *Ketua Pengarah Hasil Dalam Negeri v Success Electronics and Transformer Manufacturer Sdn Bhd* (Rayuan Sivil No. R1-14-14-09) is applicable. The functionality of the Disputed items in the overall context of the Respondent's manufacturing activity ought to be taken as a valid factor in considering the Respondent's RA claim:
  - the warehouse areas are essential and inherent in the nature of the Respondent's business.
  - the installation of fire-fighting equipment was necessary for the construction of the factory.
  - site preparation for plant installation was also vital and formed integral and incidental part of the Respondent's manufacturing activity, without which its activity would not be able to function adequately.
- The words "existing business" before the words "in respect of manufacturing or processing a product" in para 8(a) of Schedule 7A of the ITA must be read together as a whole, so that the expression *"existing business in respect of manufacturing or processing of a product" is the more probable expression which is consistent with the intention of the Legislature in enacting para.8(a) of Schedule 7A".* The submission of the Appellant that the eligibility of capital expenditure for RA shall be subject to whether that part of the building or whether the plant or machinery is involved in the manufacturing process/activity, or transforming raw materials into an end product is rejected.

  By imposing the condition of "production area" to the meaning of 'manufacturing', *"the appellant had clearly acted ultra vires, illegally and without jurisdiction….The Appellant cannot be allowed to usurp the role of Parliament by coining its own definition of "manufacturing" and drafting its own law."*
- Section 113(2) confers discretion on the Appellant as to whether penalty should be imposed or not. The matter in dispute arose as a result of technical adjustment, i.e. due to a differing interpretation of the tax legislation by the respondent and the respondent had acted in good faith and made full disclosure. The SCIT's decision relating to Issue (ii) is correct.
- There is nothing in the Appellant's submission to suggest that the SCIT had erred in their decision. Hence, appeal dismissed. Deciding Order of SCIT affirmed.

Members may read the full ***Grounds of Judgment*** from the Kuala Lumpur Law Courts Official website.

**DALAM MAHKAMAH TINGGI MALAYA DI KUALA LUMPUR**
**(BAHAGIAN RAYUAN & KUASA-KUASA KHAS)**
**RAYUAN SIVIL NO: R2-14-9-09/2012**

**ANTARA**

**KETUA PENGARAH HASIL DALAM NEGERI - PERAYU**

**DAN**

**FIRGOS (MALAYSIA) SDN BHD - RESPONDEN**

**KES DINYATAKAN OLEH PESURUHJAYA KHAS CUKAI PENDAPATAN**

**BAGI PENDAPAT MAHKAMAH TINGGI**

**MENURUT PERENGGAN 34 JADUAL 5 AKTA CUKAI PENDAPATAN 1967**
**( DI DALAM PERKARA DI HADAPAN PESURUHJAYA KHAS CUKAI PENDAPATAN)**

**RAYUAN NO. PKCP (R) 43/2010**

**ANTARA**

**FIRGOS (MALAYSIA) SDN BHD - PERAYU**

**DAN**

**KETUA PENGARAH HASIL DALAM NEGERI - RESPONDEN**

## GROUNDS OF JUDGMENT

The appellant is appealing by way of a case stated dated 4.9.2012 pursuant to paragraph 34 Schedule 5 of the Income Tax Act 1967 ("ITA") against the Deciding Order of the Special Commissioners of Income Tax ("SCIT") dated 4.5.2012.

[2] By that Deciding Order, the SCIT, unanimously allowed the appeal by way of Form Q filed by the respondent against the following assessment raised by the appellant ("the assessment") –

| Date of Form Q | Year & Type of assessment | Date Of Notice | Tax assessed (RM) |
|---|---|---|---|
| 27.8.2009 | 2005 (Additional) | 29.7.2009 | 19,305.20 |
| 27.8.2009 | 2006 (Additional) | 29.7.2009 | 294,233.72 |
| 27.8.2009 | 2007 (Additional) | 29.7.2009 | 427,689.09 |

The material part of the Deciding Order, which can be seen at pages 51-52 of the Case Stated dated 24.12.2010, read as follows:-

**"** ***ADALAH DIPUTUSKAN*** *bahawa semua perkara yang Perayu menuntut dalam tahun-tahun taksiran 2005 dan 2007 layak untuk dibenarkan tuntutan Elaun Pelaburan Semula di bawah Akta Cukai Pendapatan 1967 seperti berikut:-*

*(a) Loji dan jentera*
*Tahun Taksiran 2005*
*i) fire-fighting equipment; dan*
*ii) electrical fittings*

*(b) Kilang*
*Tahun Taksiran 2005*
*i) warehouse spaces*
*Tahun Taksiran 2007*
*i) site preparation for the installation of the plant*

***ADALAH DIPUTUSKAN JUGA*** *bahawa Responden tidak wajar mengenakan penalty di bawah Seksyen 113(2) Akta Cukai Pendapatan 1967 dalam Tahun Taksiran 2007.*

[3] The respondent is in the business of manufacturing papers, cards and boards which includes sheeting, processing and trading papers, cards and boards. The respondent had claimed for reinvestment allowance in the years of assessment 2005 and 2007 amounting to RM3,193,853.00 and RM205,964.00 respectively. The appellant, after conducting a field audit at the respondent's premise vide its letter dated 18.7.2009, disallowed the reinvestment allowance claims made by the respondent on the following items:-

Year of assessment 2005

Plant and machinery

(i) Fire-fighting equipment ( the appellant disallowed the whole capital expenditure incurred amounting to RM290,000); and

(ii) Electrical fittings ( the appellant disallowed 8/11 of the capital expenditure incurred amounting RM245,000).

Factory -

8/11 or 72.7% of the factory which is the warehouse spaces.
Consequently, the appellant disallowed 8/11 of the capital expenditure incurred on the factory which amounts to RM1,811.378).

Year of assessment 2007

Factory -
Site preparation for the installation of plant ( the appellant disallowed the whole capital expenditure incurred amounting to RM22,9000).

The appellant informed the respondent that the reinvestment allowance claims for the Disputed Items were disallowed due to the following basis-

i) The production area which qualified for reinvestment allowance was $3/11^{th}$ or 27.3% of the total floor area;

ii) Only 27.3% of the total expenditure of electrical installation is allowed;

iii) The appellant had disregarded the respondent's claim for reinvestment allowance for fire-fighting equipment;

iv) Capital expenditure for the preparation of site for the installation of plant and machinery is not eligible for reinvestment allowance under Schedule 7A of the Income Tax Act 1967;

v) The reinvestment allowance disallowed by the appellant in respect of the Disputed Items in the relevant years of assessment are as follows:-

| **Year of Assessment** | **Reinvestment allowance disallowed** |
|---|---|
| 2005 | RM1,367,695 |
| 2007 | RM13,740 |

vi) On 29.7.2009, the appellant raised notices of additional assessment ("Form JA") including penalties amounting respectively RM19,305.20 and RM427,689.09 for the years of assessment 2005 and 2007.

vii) On 27.8.2009, the respondent filed a notice of appeal ("Form Q") dated 27.8.2009 against the appellant's decision in disallowing the reinvestment allowance claimed on the Disputed Items.

[4] The SCIT had, as mentioned earlier, allowed the respondent's appeal. Hence, the appellant now appeals before this court.

## Issues

### Issue 1: Reinvestment allowance

Whether any or all of the following items claimed by the respondent in the years of assessment 2005 and 2007 qualify for reinvestment allowance under the Income Tax Act 1967:-

(a) Plant and machinery:

Year of assessment 2005:

(i) fire-fighting equipment; and

(ii) electronic fittings

(b) Factory

Year of assessment 2005:

(i) warehouse spaces.

Year of assessment 2007:-

(i) site preparation for the installation of plant.

**Issue 2: Penalty**

Notwithstanding the above, whether the appellant exercised its discretion properly and lawfully in imposing penalty under Section 113(2) of the Income Tax Act 1967 in the year of assessment 2007?

**Decision**

It is appellant's contention that the respondent was only entitled to reinvestment allowance on the capital expenditure incurred for the production area only. The appellant also contends that the SCIT had erred when they relied on the decision of the High Court in **Ketua Pengarah Dalam Negeri v Success Electronics and Transformer Manufacturer Sdn Bhd ( Rayuan Sivil No. R1-14-14-09)**; and when they held that the words "existing business" must be read together as a whole.

[2] Reinvestment allowance is available where a taxpayer has incurred capital expenditure on a factory, plant or machinery for the purposes of a qualifying project. Paragraph 1 of Schedule 7A of the ITA reads:-

*"Subject to this Schedule, where a company which is resident in Malaysia –*

*(a) has been in operation for not less than twelve months; and*

*(b) has incurred in the basis period for a year of assessment capital expenditure on a factory, plant or machinery used in Malaysia for the purposes of a qualifying project referred to under subparagraph 8(a) or (b),*

*there shall be given to the company for that year of assessment a reinvestment allowance of an amount equal to sixty percent of that expenditure."*

[3] In Success Electronics' case (*Supra*), the High Court had affirmed the SCIT's decision that reinvestment allowance cannot be restricted to "production area" alone. In that case, the High Court held that meeting room, office spaces, toilets, staircases, void areas, lift lobby, *surau,* warehouse, lightning adjustment and installations of air-conditioning, electrical fitting and partition walls were part of the factory. The High Court had affirmed the SCIT's decision and approved the following principles:-

(a) *The word 'factory' was not defined for the purpose of this reinvestment allowance ... in the absence of such express definition to the word 'factory', the word should then be given its ordinary meaning.*

*(b) A factory is a building that is used to manufacture goods which may contain areas for production and non-production.*

*(c) The imposition of the condition "production area" based on internal ruling or guidelines of the respondent are without any legal authority and therefore had no force of law.*

*(d) The respondent is not entitled to reduce or to disallow the reinvestment allowance claimed under Schedule 7A of the Act based on its own internal ruling or guidelines.*

*(e) The functionally of the claimed items in the overall context of the manufacturing process ought to be taken as a valid factor to be considered in giving the appropriate meaning to the word 'factory'.*

*(f) If the Parliament had intended for the word 'factory' to be narrowly interpreted to mean as was submitted by the Respondent, then an express definition, different from the one provided for the term factory in Schedule 2, ought to have been so provided in Schedule 7A.*

[4] I agree with the respondent that the principle enunciated in Success Electronics' case (*Supra*) shall be applicable here. As submitted by the respondent, the functionally of the Disputed Items in the overall context of the respondent's manufacturing activity ought to be taken as a valid factor in considering the respondent's reinvestment allowance claim.

[5] I also agree with the respondent that the warehouse areas are essential and inherent in the nature of the respondent's business. Even the appellant's witness agreed that the respondent's raw materials occupy a large amount of space. Without the raw materials, there would be no production. Since the respondent's raw materials are highly flammable, surely it is also good practice standard to have large spaces.

[6] To me, site preparation for plant installation was also vital and formed integral and incidental part of the respondent's manufacturing activity, without which its activity would not be able to function adequately. The appellant's witness admitted in evidence that the installation of the fire-fighting equipments was a requirement by the Fire Department to ensure the safety of the

factory and staff, without which the respondent would not have obtained the Certificate of Fitness to occupy the factory. If the respondent's raw materials were to catch fire and there was no fire-fighting equipment installed in the factory, the respondent's business operations would be disrupted and the respondent would also suffer losses. Hence, I agree with the respondent that the installation of fire-fighting equipment was necessary for the construction of the factory as the respondent's raw materials are highly inflammable.

[7] The appellant submits that the words "… in respect of manufacturing or processing of a product…" in paragraph 8(a) of Schedule 7A is a phrase that needs to come into heavy consideration in determining the respondent's eligibility to reinvestment allowance. They further submits that manufacturing process/activity is a process of production of articles for use from raw or prepared materials by giving such materials new forms, qualities, properties or combinations, whether by hand labour or machine. The appellant then submits that the eligibility of capital expenditure for reinvestment allowance shall be subject to whether that part of building or whether the plant or machinery is involved in the manufacturing process/activity, or transforming raw materials into an end product.

[8] With due respect, I cannot agree with this line of submission. The words *" existing business" found before the words "in respect of manufacturing or processing of a product'* ***must be read together as a whole****, so that the expression "existing business in respect of manufacturing or processing of a product" is the more probable expression which is consistent with the intention of the Legislature in enacting para . 8(a) of Schedule 7A.* Refer to **Metacop Development v Ketua Pengarah Hasil Dalam Negeri ( Judicial Review Application No. R2-25-389-2009)**. If Parliament had intended reinvestment allowance to be restricted only to "production area", then Parliament would have surely specified this clearly in Schedule 7A. I agree with the respondent that by imposing the condition of "production area" to the meaning of "manufacturing", the appellant had clearly acted ultra vires, illegally and without jurisdiction as such was never the intention of Parliament. The appellant cannot be allowed to usurp the role of Parliament by coining its own definition of "manufacturing" and drafting its own law.

[9] The SCIT had analyzed paragraph 8(a) of Schedule 7A and there is nothing in the appellant's submission to suggest that the SCIT had erred in their decision. The SCIT's reasoning as contained in paragraphs 10.13 to 10.16 of Enclosure 1 is self explanatory.

[10] On the 2nd issue, even the appellant's witness agreed that all the capital expenditures claimed for reinvestment allowance purposes were actually incurred by the respondent. During the cross-examination, he agreed that the respondent had made full disclosure in the Borang that were submitted in the Years of Assessment 2005-2007 and agreed that the audit team did not discover anything contrary to the information disclosed in the Borang. I therefore agree with the SCIT that the respondent had acted in good faith and made full disclosure. In **Ketua Pengarah Hasil Dalam Negeri v Kim Thye & Co [1992] 2 MLJ 708** it was highlighted that Section 113(2) of the ITA is not a mandatory provision. This section clearly confers discretion on the appellant as to whether penalty should be imposed or not. What more the matter in dispute arose as a result of technical adjustment i.e due to a differing interpretation of the tax legislation by the respondent. Therefore, the decision of the SCIT in the 2nd issue to my mind is also correct.

## **Conclusions**

The SCIT was right when they relied on Success Electronics' case (*Supra*) as the case binds them. The appellant should have also take the same step because unless and until the Court of Appeal sets aside the decision in Success Electronics (*Supra*), the decision is a binding authority. Refer to Metacorp Development's Case (***Supra***)

[2] Under the circumstances, I affirm the deciding order of the SCIT dated 4.5.2012 and the appeal is therefore dismissed with costs.

**DATO' ZALEHA BINTI YUSOF**
**JUDGE**
**HIGH COURT OF MALAYA**
**KUALA LUMPUR.**

**Dated**: 30th January 2013

**For the Appellant:** Neng Juliana Bt Ismail with Wan Hamdenie bt Wan Mohamed; Lembaga Hasil Dalam Negeri

**For the *Respondent*:** Datuk Palpanaban Devarajoo with Saravana Kumar Segaran and Donovan Lee Shyun Hun; Messrs Lee Hishammudin Allen & Glehdhill