DALAM MAHKAMAH RAYUAN MALAYSIA DI PUTRAJAYA

(BIDANG KUASA RAYUAN)

RAYUAN SIVIL NO: W-01(A)-561-09/2021

ANTARA

KETUA PENGARAH HASIL DALAM NEGERI … PERAYU

DAN

ABTP MARKETING SDN. BHD. ... RESPONDEN

[Dalam Mahkamah Tinggi Malaya di Kuala Lumpur
(Bahagian Rayuan dan Kuasa-Kuasa Khas)
Rayuan Sivil No. WA-14-53-12/2020

Antara

Ketua Pengarah Hasil Dalam Negeri ... Perayu

Dan

ABTP Marketing Sdn. Bhd. ... Responden

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Ketua Pengarah Hasil Dalam Negeri ... Responden

Dalam Perkara Pesuruhjaya Khas Cukai Pendapatan
Rayuan No. PKCP(R) 102/2016; 103/2016; 104/2016

Antara

ABTP Marketing Sdn. Bhd ... Perayu

Dan

Ketua Pengarah Hasil Dalam Negeri ... Responden]

KORAM:

RAVINTHRAN PARAMAGURU, HMR
HASHIM BIN HAMZAH, HMR
LIM CHONG FONG, HMR

GROUNDS OF JUDGMENT

Introduction

[1] This is an appeal against the decision of the High Court that dismissed the appeal of the Director General of Inland Revenue (the Revenue) and at the same time allowed the appeal of the taxpayer, i.e. ABTP Marketing Sdn Bhd (ABTP). Both appeals before the High Court were from the deciding order of the Special Commissioners of Income Tax (the SCIT) in respect of ABTP's appeal against additional assessment.

Background facts

[2] The basic undisputed facts extracted from the judgment of the High Court and the grounds of decision of the SCIT are as follows.

[3] ABTP was appointed as the marketing channel for anti-bacterial triple-layer polymer water pipes for another company, namely ME-Plas (M) Sdn Bhd (ME-Plas). The issues before the SCIT and High Court centred on the claims for deductions by ABTP for the Years of Assessment (YA) 2010, 2011 and 2012.

[4] The complex business relationship between ABTP and ME-Plas worked this way. ABTP purchased two PVC mixing machines and placed them in ME-Plas's premises. ABTP purchased raw materials from a third party for the manufacture of the anti-bacterial compounds. It then supplied the said raw materials to ME-Plas which mixed the same into anti-bacterial triple polymer compounds for ABTP. ME-Plas charged ABTP for mixing the compounds through debit notes. ME-Plas then purchased the compounds from ABTP and manufactured the anti-bacterial polymer pipes (also known as "AB-3P pipes"). ABTP as the marketing channel company purchased the said pipes from ME-Plas.

[5] The arrangement between the parties contained the following stipulations as reflected in the Authorisation Letter signed by both parties.

(i) ABTP shall achieve a minimum of 2,000 tons of the AB-3P pipes purchase orders per year.

(ii) If ABTP fails to make a minimum order of 2000 tons per year/1000 tons per every 6 months, ABTP will be charged by

ME-Plas, a factory original equipment manufacturer (OEM) surcharge on the difference (the OEM surcharge).

[6] Arising from the above arrangement, ABTP made a number of claims for deduction for YA 2010, YA 2011 and YA 2012. After an audit made in 2014, the Revenue raised additional assessment for the same years in respect of the said claims. The Revenue also imposed a penalty under section 113(3) of the Income Tax Act. ABTP appealed to the SCIT. The appeal was partially allowed.

[7] The claims for deduction decided by the SCIT and the High Court involved the following issues:

(a) Whether the claim for deduction of the OEM surcharge via two debit notes of RM544,150.00 and RM255,845.79 can be allowed;

(b) Whether the Research and Development (R&D) expenditure of RM226,651.55 for the YA 2011 and 2012 is an allowable deduction under section 34(7) of the ITA?

(c) Whether the upkeep or repair and maintenance in the sum of RM100,000.00 in the areas of ME-Plas's factory where the mixing machines owned by ABTP are placed is an allowable deduction;

(d) Whether the commission and interest of RM660,904.84 for YA 2912, RM151,435.37 for YA 2011 and RM25,849.75 for YA 2010 are allowable deductions. These items include (i)commission paid for purchase of raw materials including bankers' acceptance commission, (ii) interest incurred on

money borrowed, (iii) director's remuneration, (iv) labour charges and (v) sales commission;

(e) Whether the capital allowance and hire purchase interest for the machinery owned by ABTP that was placed in ME-Plas's factory in the sum of RM353,521.00 for YA 2010, 2011 and 2012 can be deducted;

(f) Whether penalty was correctly imposed on ABTP for making an incorrect return under section 113(2) of the Income Tax Act 1967.

Decision of SCIT

[8] The SCIT did not allow the deduction for the OEM surcharge and maintenance of the factory. They allowed the deduction for the R & D expenditure and capital allowance and hire purchase interest for the machinery owned by ABTP. The SCIT did not allow deduction for commission paid for raw materials and banker's commission. The other expenses were all allowed and found to be deductible. As the appeal was only partially successful, the SCIT upheld the decision to impose penalty under section 113(1) of the ITA.

Decision of High Court

[9] The learned High Court Judge allowed the appeal of ABTP and dismissed the appeal of the Revenue which means that all the expenses were held to be deductible. The decision of the Revenue to impose the section 113(2) penalty was also set aside by the High Court.

Our decision

[10] Briefly stated, the reasons of the High Court for allowing the five claims for deduction are as follows.

[11] In respect of the OEM surcharge, the main argument of the Revenue which was accepted by the SCIT was that it was a penalty and therefore it was not a deductible expense. The learned High Court judge pointed out that none of the contractual documents in this case state that the OEM surcharge was a penalty. In other words it is a reasonable compensation pursuant to the contract.

[12] We are in complete agreement with Her Ladyship's reasoning. The OEM surcharge is not mandatorily payable; it is only payable if the purchase orders fall below a certain limit. As Her Ladyship said, the purpose is to cover the costs of producing the pipes. Thus, it was wholly incurred in generating revenue. The House Lords case of *Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Limited Company* [1915] AC 79 cited by the learned High Court Judge is on point. The House of Lords said as follows in that case in considering whether an expense is a penalty:

> (a) It will be held to be penalty if the sum stipulated for its extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach, (Illustration given by Lords Halsbury in Clydebank Case. (3)
>
> (b) It will be held to be penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid (Kemble v Farrent (4)).....

(c) There is a presumption (but no more) that it is penalty when "a single lump sum is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage" (Lord Watson in Lord Elphinstone v Monkland Iron and Coal Co. (6)

On the other hand:

(d) It is no obstacle to the sum stipulated being a genuine pre-estimate of damage, that the consequences of the breach are such as to make precise pre-estimation almost an impossibility. On the contrary, that is just the situation when it is probable that pre-estimated damage was true bargain between the parties."

As pointed out by the learned High Court Judge, none of the conditions stated in the *Dunlop* case are present in the instant case for the OEM surcharge to be considered a penalty.

[13] In respect of the R & D expenditure, which included raw material purchases and costs of travel to South Korea, the Revenue's argument to support its case that it is not claimable is two-fold. The trip to South Korea was undertaken by ME-Plas on behalf of ABTP. Firstly, it was argued that the ABTP is trading company and that it is not in the business of manufacturing the AB-3P compounds. The mixing is done by ME-Plas and therefore the expenditure belonged to it and not to ABTP. The alternative argument was that since the ABTP claimed that the intellectual property in the compounds that belonged to it, the expenditure in question is capital in nature and therefore not deductible under section 33(1) of the ITA.

[14] The learned High Court Judge agreed with the SCIT that the business of ABTP cannot be restricted to trading only. The SCIT made a finding of fact that ABTP had expanded its business beyond trading and had entered into an agreement with ME-Plas for the latter to carry out R & D activities on its behalf for the purpose of producing the anti-bacterial compounds. We agree with the learned High Court Judge and the SCIT that a taxpayer cannot be restricted in its business to generate revenue. In the instant case, ABTP and ME-Plas had entered into a particular arrangement whereby the former which is primarily a trading company nonetheless had decided to own the anti-bacterial compounds produced by the latter in its factory. As we said earlier, the compounds were sold to ME-Plas by ABTP. Therefore, as the learned High Court Judge noted, the R & D expenditure in question cannot be claimed by ME-Plas as a deductible expense in the production of its income. Rather, it was incurred in the production of the income of ABTP as found by SCIT and the High Court.

[15] Thus, the only relevant question is whether the R & D expenditure is "an outgoing and expense" that was wholly and exclusively incurred in the relevant taxable period for the production of income as stipulated under section 33(1) and at the same time not caught as a capital expense under section 39(1)(c) of the ITA. Section 39(1)(c) of the ITA reads as follows:

> 39. Deductions not allowed
>
> (1) Subject to any express provision of this Act, in ascertaining the adjusted income of any person from any source for the basis period for a year of assessment no deduction from the ross income from that source for that period shall be allowed in respect of—

(c) any capital withdrawn or any sum employed or intended to be employed as capital;

[16] In *Syarikat Jasa Bumi (Woods) Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* [2000] 2 MLJ 317 that was cited by counsel for the appellant, the Court of Appeal said as follows:

> In our view, for a taxpayer to qualify for deduction of any payment or expenditure incurred by him he must first of all place the payment or expenditure as allowable under s 33 of the Act. He has to justify that the payment or the expenditure incurred by him is an allowable deduction under s 33 of the Act. In the present appeal it is sub-s (1) of that section. If the payment or expenditure is not allowed under s 33(1) of the Act then it would not be allowed as a deduction. On the other hand, if it is allowed as a deduction under s 33(1) of the Act, one has to proceed to the next step to ascertain whether the payment is caught under s 39(1) of the Act. If it is caught under s 39(1) of the Act, then it would not be allowed as a deduction though it is allowable under s 33(1) of the Act.

[17] In order to answer the question whether the claim is a capital expenditure, it is necessary to delve into the nature of the R & D expenditure. Counsel for appellant submitted that one of the tests to determine whether an expenditure is capital or revenue is the "enduring benefit" test laid down in *British Insulated and Helsby Cables, Ltd v Atherton* [1926] AC 205, where the House of Lords said as follows:

> But 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, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital. For this view there is already considerable authority. Thus, moneys expended by a brewing firm with a view to the acquisition of new licensed premises: *Southwell v. Savill*

Brothers(1); "flitting expenses" incurred in transferring a manufacturing business to new premises: *Granite Supply Association v. Kitton*(2); costs incurred in promoting a Bill which was dropped on the desired facilities being obtained by agreement: *A. G. Moore & Co. v. Hare*(3); and expenditure incurred by a shipbuilding firm in deepening a channel and creating a deep water berth (not on their own property) to enable vessels constructed by them to put out to sea: *Ounsworth v. Vickers, Ld*.(4), have been held to be in the nature of capital expenditure and not to be deductible under the Income Tax Acts; and *Rowntree & Co. v. Curtis*(5) is to the same effect. I think that the principle to be deduced from this series of authorities rests on sound foundations and may properly be adopted by this House.

[18] Counsel for the appellant submitted that in the instant case, the purpose of the trip to South Korea was to obtain the “formula or know-how” to make the anti-bacterial compounds. Therefore, it is an expenditure made with a view to bring into existence an asset or an advantage for the enduring benefit of ABTP’s trade. We find merit in this argument. Counsel for the respondent had incidentally also submitted that the purpose of the R & D trip to South Korea was to obtain the formula to manufacture the anti-bacterial compound locally. Previously, it was manufactured in South Korea. This fact was also noted by the SCIT when they said as follows:

10.13 AW2 juga ada memberikan keterangan mengenai perjalanan yang beliau lakukan ke Korea untuk berunding dengan syarikat Korea bagi mendapatkan formula pembuatan *AB-3P compound* bagi membantu penyelidikan yang dijalankan oleh syarikat ME-Plas Sdn. Bhd. AW2 juga memberikan keterangan mengenai penambahbaikan yang dibuat oleh syarikat ME-Plas Sdn. Bhd. Hasil daripada penyelidikan yang dijalankan.

10.14 AW2 juga ada memberikan keterangan bahawa tujuan penyelidikan dijalankan adalah supaya bahan asad pembuatan AB-3P paip iaitu

> AB-3P *compound* yang sebelum ini diperolehi daripada syarikat pengeluar di Korea dihasilkan sendiri di dalam Malaysia dan ini dapat mengurangkan kos pembelian bahan asas tersebut daripada syarikat pengeluar Korea.

[19] Therefore, as submitted by counsel for the appellant, the advantage obtained by ABTP in the R & D expenditure has permanency and enduring benefit for its business. Therefore, whilst we accept that ABTP has a right to expand its business and get involved in the production of the anti-bacterial compound by using the factory belonging to ME-Plas, the point about the capital nature of the R & D expenditure was not properly dealt with by both the SCIT and the High Court. This is a matter of law which we can interfere with. We shall therefore vary this part of the decision of the SCIT and the High Court and hold that the R & D expense was caught by section 39(1)(c) as it was substantially a capital expenditure.

[20] In respect of the expense of RM100,000.00 to maintain ME-Plas's factory where the anti-bacterial compounds were mixed on behalf of ABTP, it is a fact that the machinery belonged to ABTP. The Revenue again contended that the business of the ABTP was only marketing the pipes and therefore it cannot claim for the maintenance of the factory where the machines were installed. The SCIT had no issue with the fact that the machines were owned by ABTP. In fact, the SCIT said when considering the R & D issue that ABTP cannot be restricted to only marketing the completed anti-bacterial pipes as contended by the Revenue. The only reason, the claim of RM100,000.00 was not allowed was because the maintenance invoice for the said sum was not produced.

[21] We agree with the learned High Court Judge that section 33(1)(c) of the ITA does not say that a taxpayer must own the premises in order to deduct maintenance expense. It is undisputed that the machines were owned by ABTP and that they were used in the production of its income, i.e. the compound used by ME-Plas to manufacture the anti-bacterial pipes. Although the maintenance invoice was not tendered, ABTP tendered evidence through AW1 and AW2 that maintenance expenses were paid by one of its directors personally and the payments were recorded in its books as "an amount owing to the Director". ABTP had also assumed the contractual obligation to maintain the machines as noted by the learned High Court Judge. We therefore affirm the decision of the learned High Court Judge who held that machinery maintenance expenses comes under section 33(1) of the ITA as expenses incurred in producing income.

[22] We shall now consider whether commission and interest payment incurred for purchase of raw materials and other payments incurred by ABTP are deductible. The payments were in respect of the following:

(a) Commission paid for purchase of raw materials including Banker's acceptance commission in the sum of RM465,243/00;

(b) Interest of 5 per cent incurred on money borrowed;

(c) Director's remuneration;

(d) Labour charges and;

(e) Sales commission.

[23] At the outset of the hearing, counsel for the appellant conceded the claim for director's remuneration and labour charges. Thus, only the three remaining items were disputed.

[24] ABTP claimed the commission paid to its raw material suppliers as an expense under section 33(1). The raw materials were for the purpose of producing the anti-bacterial compound. The raw materials suppliers charged ABTP commission for this reason. ABTP used the credit facility of the raw material suppliers to make the purchase. The learned High Court Judge held that it was a deductible expense because it can be equated with interest charged by commercial banks. Her Ladyship cited section 33(1)(a) which enacts that interest expenses on money borrowed in the production of gross revenue is a deductible expenditure. She found that the commission paid for the use of the credit facility in question was limited to raw materials used in the production of income and did not involve assets of enduring value.

[25] On the other hand, counsel for the appellant raised the argument that was accepted by the SCIT which is that there was no agreement or documents evidencing ABTP's obligation to pay the commission. The relevant passage of the grounds of decision of the SCIT that was relied on by counsel for the appellant is as follows:

> 10.25 Berkenaan perbelanjaan komisyen pembelian bahan mentah kami mendapati tiada apa-apa perjanjian atau dokumen sokongan yang boleh menjelaskan komposisi komisyen tersebut. Adakah ia merupakan bayaran faedah bank atau merupakan bayaran komisyen atas penggunaan kemudahan pinjaman bank, tiada keterangan diberikan oleh Perayu. Tiada juga saksi dipanggil daripada pihak yang membenarkan kemudahan pinjaman bank mereka digunakan bagi menjelaskan komposisi komisyen tersebut. Oleh itu kami

memutuskan tidak selamat untuk kami membenarkan tuntutan perbelanjaan ini.

[26] In our view, the learned High Court Judge correctly dismissed the above-mentioned argument of counsel for the appellant. Her Ladyship pointed out that the law does not require a written agreement between ABTP and the raw material supplier in the matter of determination of deductibility of an expense, i.e. the commission for use of the credit facility. The documents used in the transaction, such as the vouchers that were tendered before the SCIT, constituted proof of payment of the said commission. We see no error in this reasoning. After all, even the SCIT agreed that ABTP cannot be limited to marketing of the pipes but can venture into production of the anti-bacterial compound. Therefore, as ABTP had proved that it had paid the commission payment in question to the raw material suppliers for use of the latter's credit facility, the expense clearly comes within section 33(1) to the ITA. We are also of the view that that argument of the counsel for appellant that ABTP has its own bank facilities is not relevant. There is nothing in the ITA that prevents a tax payer from making financing arrangements other than using its existing banking facilities.

[27] The learned High Court Judge also found that the 5 per cent interest on the loan given to ABTP by one Liew Teng Shuen to purchase raw materials was a deductible expense. The SCIT also allowed the interest payment as it was stated on the payment invoices. We are of the view that both the learned High Court Judge and the SCIT correctly found that as the interest payment was incurred in the process of purchasing of raw material to generate revenue, it was not a capital expenditure. The only argument canvassed by counsel for the appellant was that there was

no finding by the SCIT in respect of the purpose of the loan. However, reading the grounds of decision of the SCIT as a whole, it is clear that the tribunal approached the loan as the source of funding for purchase of raw materials. That was the case of ABTP as well before the SCIT. This is the reason the High Court found that the loan was for the purpose of generating revenue as it relates to the costs of goods sold and that it did not add to the capital structure of ABTP. We shall therefore affirm the decisions of the SCIT and the High Court that found that the 5 per cent interest on the loan was a deductible expense.

[28] The second last issue on expenses is the issue of sales commission. The SCIT found that commission of RM90,034.00 was paid to Kho Lip Khiong for the sale of the AB-3P pipes was for the production of income and was therefore a deductible expense. The sales commission of 5 per cent was documented on the sales invoices. The SCIT found that this fact constituted sufficient proof of payment. Counsel for the appellant argued that the deductibility of an expense does not depend on the existence of an invoice but on the purpose of the payment. However, it is clear from the grounds of decision of the SCIT that the payment of 5 per cent was commission paid to Koh Lip Khiong for sales of the AB-3P pipes. We shall therefore affirm the decisions of the SCIT and the High Court in respect of the said sales commission.

[29] The final issue on deductibility of expenses that was raised before the SCIT and considered by the High Court was the capital allowances in respect of the machines in question owned by ABTP that were installed in the premises of ME-Plas and the hire purchase interest paid for purchase of the same. Both the SCIT and the High Court found for the taxpayer. The argument of the Revenue was the same argument that was raised in

respect the maintenance and repair of the machines. It was submitted that the machines were not used by ABTP as they were located in the premise of ME-Plas. We agree with the High Court that the expenses are deductible for the same reasons that we addressed earlier. The machines were owned by ABTP and the machines were used to produce the anti-bacterial compound for ABTP's business.

Penalty

[30] With regard to penalty, we affirm the decision of the Revenue to impose a penalty of RM226,654.00 in respect of the incorrect return pertaining to the R & D expenditure that we found not to be deductible.

Conclusion

[31] In conclusion, the appeal is allowed in part. We shall vary the decision of the High Court in respect of the R & D expense and the penalty imposed under section 113 of the ITA in respect of the same as stated earlier. The rest of the decision of the High Court is affirmed. No order as to costs.

SGD

(RAVINTHRAN PARAMAGURU)
Judge
Court of Appeal Malaysia
Putrajaya

Dated: 22nd August 2023

Parties Appearing:

For The Appellant:

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