

Tax e-Alert

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Shedding Light On The Proviso To Paragraph 1 Of Schedule 7A

The interpretation of the proviso to paragraph 1 of Schedule 7A of the Income Tax Act 1967 (ITA) was a bone of contention before the Court of Appeal. The *Marigold Industries* case has the distinction of being the first case where this proviso was subjected to judicial scrutiny.

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Our tax lawyers successfully represented the taxpayer, Marigold Industries, before the Court of Appeal.

Issue

The issue was whether the Systems, Applications and Products in Data Processing (SAP) system used by the taxpayer fell within the ambit of the proviso of paragraph 1 of Schedule 7A.

Facts

The taxpayer is in the business of manufacturing and selling rubber gloves. For the years of assessment 2001 to 2006, the taxpayer claimed reinvestment allowance on a qualifying project that it undertook. In 2009, the Inland Revenue Board (IRB) conducted a tax audit and disallowed the taxpayer's reinvestment allowance claim, among others, on the SAP system.

The Law

Paragraph 1 of Schedule 7A of the ITA reads:

- "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,*

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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.”

The proviso to paragraph 1 of Schedule 7A, which was the focus of judicial scrutiny, states:

“Provided that such expenditure shall not include capital expenditure incurred on plant or machinery which is provided wholly or partly for the use of a director, or an individual who is a member of the management, or administrative or clerical staff.”

Paragraph 8(a) of Schedule 7A defines “qualifying project” as:

“... a project undertaken by a company, in expanding, modernising or automating its existing business in respect of manufacturing or processing of a product of any related product within the same industry or in diversifying its existing business into any related product within the same industry”.

What the proviso aims to achieve is that even if a taxpayer satisfies paragraphs 1 and 8 of Schedule 7, he is not eligible for reinvestment allowance if the plant or machinery is wholly or partly for the use of a director or an individual who is a member of the management, administrative or clerical staff. This restriction is limited to reinvestment allowance on plant or machinery only, and does not include factory. Hence, the section of the factory that is used as an office or meeting rooms by management or administrative staff would still render the taxpayer eligible for reinvestment allowance, as held in the *Success Electronics* case.

High Court’s Decision

Among others, the High Court observed that:

- (a) In the *Syarikat Kion Hoong Cooking Oil Mills* case, the purpose of paragraph 1 of Schedule 7A was aptly described as follows:

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“The reinvestment allowance under paragraph 1 acts as an incentive to incur capital expenditure on plant machinery and factory for a qualifying project. The relief granted is for expanding money on plant and equipment used to manufacture products... To my mind the allowance/incentive granted under paragraph 1 of Schedule 7A is to increase or promote productivity through the use of new/modern efficient plant and machinery by giving a reinvestment allowance on capital expenditure...”

- (b) Following the *Palm Oil Research and Development Board Malaysia* case, Schedule 7A should be given a purposive interpretation. The Schedule provides a “special incentive relief” to companies resident in Malaysia that have been in operation for not less than 12 months, to invest in the expansion, modernisation or automation of their product manufacturing or processing.
- (c) Accordingly, the proviso to paragraph 1 should be construed in a manner that promotes the purpose of Schedule 7A.
- (d) The purpose of the proviso to paragraph 1 is to disallow reinvestment allowance when the “capital expenditure is incurred on plant and machinery which is provided wholly or partly for the use of a director, or an individual who is a member of the management, or administrative or clerical staff”. The proviso does not apply when the purpose of the capital expenditure is for the use of a taxpayer company’s “factory” for the purposes of a qualifying project.

Appeal Before The Court Of Appeal

The issue before the Court of Appeal was essentially whether the High Court’s decision was wrong in law.

We highlighted that the High Court held that the Special Commissioners were correct to apply the *Success Electronics* case by taking into account the functionality of the SAP system and the relevant computer equipment in determining whether these items

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were involved in the taxpayer's manufacturing business. Among others, the following were considered by the Court of Appeal in arriving at its decision:

- *Integral part of manufacturing*

To ensure efficiency and to reduce wastage of raw materials, each manufacturing stage was recorded by entering all information into the taxpayer's SAP system with the help of barcode scanning. The SAP system helped to eliminate human errors caused by manual entries of records of all movements in each manufacturing stage.

- *Functions of the SAP system*

The taxpayer invested in various types of computer equipment between 2001 and 2006, including a software system known as SAP. This was part of its expansion and modernisation activity for the purposes of recording the various stages of its manufacturing activity in order to improve efficiency by comprehensively monitoring all the functionality needed for the day-to-day manufacturing activity.

The various manufacturing stages were linked to one centralised network using the relevant computer equipment, which enabled the SAP system to collate and monitor all the relevant information pertinent to the taxpayer's manufacturing stages, such as the raw material stocks and procurement of the same, management of raw materials, details of work in progress, sales and service delivery management as well as financial management and reporting.

- *Application of proviso to paragraph 1*

The High Court was satisfied that the SAP system was not for the use of a director, or an individual who is a member of the management, or administrative or clerical staff, as contended by the IRB. The High Court added that the IRB failed to adduce sufficient evidence before the Special Commissioners to prove its contentions.

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- *Burden of proof*

Where the decision of the Special Commissioners is appealed to the High Court, the burden lies on the appellant to satisfy the court that the decision was based on misconception of the law or their conclusion cannot be supported by the primary facts. As the IRB was the appellant here, it bears the legal onus to satisfy the High Court that the Special Commissioners' decision was erroneous.

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Conclusion

This decision marks an important milestone as it provides some much-needed clarity in understanding the operation of the proviso to paragraph 1 of Schedule 7A. The IRB's narrow reading and application of the proviso are not supported by law. It is imperative for the IRB to appreciate that tax incentive provisions such as Schedule 7A must be interpreted and applied in a manner that achieves Parliament's objective.

Please contact us at tax@lh-ag.com for further clarification.

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