Deduction of Input Tax
by Ivy Ling Yieng Ping

Article 96 of the Federal Constitution provides that no tax or rate shall be levied by or for the purposes of the Federation except by or under the authority of the federal law. In that regard, Parliament legislated to introduce a value-added tax, known as the Goods and Services Tax ("GST"), on 5 May 2014. The Goods and Services Tax Act 2014 ("GST Act") received Royal Assent on 9 June 2014 and was gazetted on 19 June 2014. The GST replaced the sales tax and service tax administered previously under the Sales Tax Act 1972 and the Service Tax Act 1975, and came into effect from 1 April 2015 in Malaysia.

GST is often described as a broad-based consumption tax due to the width of its coverage and is “tax neutral” to business by falling on final consumption. One of the key features of the GST system is the input tax recovery mechanism, which allows a registered person to recover the GST incurred (input tax) for the taxable supplies he makes in the course or furtherance of his business. A thorough understanding and effective utilisation of the input tax recovery mechanism by a taxable person are vital to avoid cascading of GST and to ensure that the GST incurred will not be a cost to the business. Failure by a taxable person to administer and observe the rules in relation to the deduction of input tax will result in unnecessary GST liabilities to the business. Careful administration and effective utilisation of the input tax recovery mechanism is a perfectly legitimate way to minimise GST liabilities and enhance tax efficiency.

We shall discuss an issue recently experienced by the property developers when seeking to deduct input tax in their GST returns. The relevant rules and principles of the input tax recovery mechanism will also be discussed in the course of addressing the issue.

Input tax recovery issue faced by property developers

It is common for a property developer to set up a special purpose vehicle ("SPV") for a particular development project. Generally, a development project will take two to three years to complete. As a general rule, input tax can be claimed for the GST incurred by a taxable person for the taxable supply he makes. For a commercial or industrial development project, the anticipated taxable supplies (e.g. selling or leasing these properties) are expected to be made after the completion of the project. As such, a GST-registered SPV will be deducting the input tax incurred during the process of constructing and developing the project. The immediate GST consequence is that the SPV, while incurring a large amount of input tax from the construction costs, would have a very low or no corresponding output tax during the development period. This means that the SPV would be in a “refund position” instead of a “paying position” for most of its taxable periods before the completion of the project.

The author is aware that the Royal Malaysian Customs Department ("Customs") has, in certain instances, rejected the input tax refund claimed by an SPV that deducted input tax under those circumstances. The basis of such rejection being no corresponding output tax in the taxable period when input tax was deducted. There have also been cases where Customs informed an SPV that the input tax will be accumulated and brought forward until such time when the entire project is completed, or when the SPV starts to make a taxable supply to sell or lease the completed property. This would result in severe cash flow issues, and thus cause an uproar in the property development industry.

There is no doubt that the way Customs, as the administrator of GST, interprets the relevant sections of the GST Act and the GST regulations would have a huge impact on whether a SPV, in the above circumstances, can continue to enjoy the benefit of tax neutrality as a taxable person.
However, the author is of the view that Customs’ interpretations on this issue may not be consistent with the relevant GST law. In order to deal with the issue, it is necessary to familiarise oneself with the operation of input tax recovery mechanism and the relevant legislation.

Input tax recovery mechanism

Operation of mechanism

In essence, the input tax mechanism is designed for a taxable person to recover the GST he incurred as part of his business cost or expenditures. In computing the GST return, a taxable person is allowed to deduct the total value of input tax that he has incurred against the total value of his output tax.5

There is currently no case law for GST in Malaysia. Reference can be made to the case law decided in jurisdictions abroad. In the UK, Scarman LJ explained the gist of the input tax recovery mechanism as follows:6

“Value-added tax, where chargeable is a tax on the supply of goods and services. The scheme of the tax is that a trader pays tax to him of goods and services. The tax so paid is described as an input tax. That trader, when he comes to supply his customers with goods or services, charges them with tax on the supply, and the tax that he charges his customers is described as output tax. Thus, a trader pays input tax but collect output tax. He is subject, of course, to the duty to make a periodic account to the commissioners. When he makes that account, he is entitled to deduct the amount of input tax paid from the amount of output tax charged; and he is liable to the commissioners for the balance. If the input tax exceeds the output tax charged, he can claim a payment from the commissioners.

“This simple scheme creates no difficulties at all if the whole of the supplies that the trader makes to his customers are themselves taxable supplies. He can then deduct the whole of the input tax that he had paid during the appropriate period. But if the trader makes a number of supplies to customers which are exempt from, ie do not attract, the tax, then he can only deduct against the output tax that the has collected from other transactions so much if the input tax which he has paid as is properly attributable to the output tax. Complex regulations exceed for determining attributability…”

However, not all GST incurred as business cost is deductible by a taxable person. In reality, whether a taxable person is entitled to deduct a particular input tax he incurred is subject to a series of complex rules. In order for GST incurred to be deductible, the GST must first qualify to be treated as input tax of the taxable person.

Meaning of input tax

Input tax has the meaning given to it under s 2 of the GST Act as tax7 on any supply of goods or services to a taxable person; and tax paid or to be paid by a taxable person on any importation of goods, and the goods or services are used or are to be used for the purposes of any business carried on or to be carried on by the taxable person. It is further provided in the same section that where the goods or services are used or are to be used partly for the purposes of any business carried on or to be carried on by the taxable person. It is further provided in the same section that where the goods or services are used or are to be used partly for the purposes of any business carried on or to be carried on by the taxable person and partly for other purposes, tax on the supply and importation shall be apportioned so that only so much as is attributable to the purposes of his business is counted as his input tax. If the goods or services are incurred for any purposes other than for the purposes of business, the GST paid will not qualify as an input tax incurred by a taxable person.

It follows from the above definition of input tax8 that these conditions must be satisfied for the tax incurred to be treated as input tax:

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5 See ss 38(1) and 39(1) of the GST Act
6 British Airports Authority v C & E Comrs [1977] STC 36 at 38
7 Under s 2 of the GST Act, “tax” in the GST Act means Goods and Services Tax
8 See definition under s 2 of the GST Act
(a) There must be a taxable person;9

(b) There must either be a supply made to that person or an importation of goods of goods in respect of which that person is to pay any GST arising;

(c) GST must actually arise on the supply or importation; and

(d) The input tax credit must be incurred for the purposes of any business carried on or to be carried on by the taxable person.

If all above conditions are fulfilled, the GST incurred by a taxable person can be considered as his input tax.

**Meaning of output tax**

As explained above, input tax is to be deducted from the output tax charged on the taxable supply of goods or services made by a taxable person. Output tax has the meaning given to it under s 2 of the GST Act as tax10 on any taxable supply of goods or services made by a taxable person in the course or furtherance of his business in Malaysia. Taxable supply includes supply which is standard-rated or zero-rated but does not include an exempt supply.11 Practically speaking, there would be no output tax to be accounted by a taxable person for both zero-rated and exempt supply. However, input tax deduction is only allowed if it is incurred to make taxable supply.

**Basic rules for deduction of input tax**

For any taxable supply made in Malaysia, the amount of input tax credit a taxable person is entitled to deduct is provided under s 38(1) and s 39(1) of the GST Act. In essence, the amount of input tax for which a taxable person is entitled to credit at the end of any prescribed taxable period (whether monthly or quarterly12) shall be so much of the input tax for the period that is **allowable and attributable** to the taxable supplies (including disregarded supply) or any other prescribed supplies made or to be made by the taxable person in the course or furtherance of any business in Malaysia. Input tax deduction can also be made for input tax incurred for any supply made outside Malaysia, which would be a taxable supply if made in Malaysia.

Upon the input tax deduction, if the input tax amount exceeds that of the output tax, the taxable person would be in a “refund position”, where he is entitled to a refund of the exceeded amount from the Director General (“DG”).13 Otherwise, the taxable person would be in a “paying position”, where he is required to account the output tax after the input tax deduction to Customs.

**Whether there is any legal basis for Customs to reject input tax deduction based on the fact that there is corresponding output tax in relevant taxable period**

The author is aware that Customs may adopt a “matching concept” in offsetting the input tax credits against the output tax for a taxable period. In other words, Customs is likely to reject the input tax refund claimed by SPV on the basis that the corresponding output tax is not made in the taxable period when the input tax credit is claimed as the development project can only be completed after two to three years.

The author is of the view that the law does not require the corresponding output tax to be made in the taxable period when the taxable person made a deduction of input tax. It would be absurd to suggest that the output tax for a particular supply needs to be accounted for by the taxable person when he deducts the input tax he incurred to make that supply. In fact, such notion is contrary to the basic rules and principles of the input tax recovery mechanism.

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9 See meaning of “taxable person” under s 2 of the GST Act
10 Tax in this instance is referred to as GST
11 See s 2 for definition of taxable supply
12 Monthly return for a taxable person who has a total taxable supply of RM5 million or more and quarterly return for a taxable person if the total taxable supply is below RM5 million. See s 40(1)(a)(b) of the GST Act.
13 GST Act, s 38(3)
Suppose that Factory A, a glass bottle manufacturer, purchased raw materials from its supplier in April 2016 to produce glass bottles. It paid off its supplier in May 2016 and received a tax invoice from the supplier. Factory A took two months to manufacture the glass bottles and sold the glass bottles to B three months later in October 2015 and issued a tax invoice to the effect. Factory A, which is required to file GST return on a monthly basis, accounted for the output tax in the taxable period of October 2015 to comply with the time of supply rule.\textsuperscript{14}

Based on the Customs’ view, Factory A will not be allowed to deduct its input tax incurred in taxable period of May 2016 until such time when the output tax for the glass bottles is accounted for by Factory A. For Factory A to deduct the input tax, it must keep track of the supplies it makes and ensure that in the taxable period when it accounts for the output tax, it also deducted the necessary input tax incurred to made the supply so that it is tax neutral to the business. However, this is inconsistent with the rules of input tax deduction discussed earlier. In particular, Reg 38(1) allows the taxable person to deduct input tax when he holds a tax invoice issued by the supplier.

In addition, the author is of the view that Customs’ view is contrary to the express wording of the GST Act.

Section 38 of the GST Act provides:

"(1) Any taxable person is entitled to credit for so much of his input tax as is allowable under section 39 to be deducted from any output tax that is due from him." (Emphasis added)

Section 39 of the GST Act provides that:

"(1) The amount of input tax for which any taxable person is entitled to credit in any taxable period shall be so much of the input tax for the period that is allowable and reasonable to be attributable, as may be prescribed, to the following supplies made or to be made by the taxable person in the course or furtherance of any business in Malaysia:

(a) any taxable supply, including a taxable supply which is disregarded under this Act;

(b) any supply made outside Malaysia which would be a taxable supply if made in Malaysia; or

(c) any other supply as may be prescribed." (Emphasis added)

Section 39(1)(a) of the GST Act clearly provides that a taxable person is entitled to input tax credit for the taxable supply made or to be made by the taxable person. It is therefore apparent from the wording of the Act that the taxable supply does not have to be made in the taxable period when an input tax is deducted by the taxable person. As such, there is no requirement as to when the taxable supply should be made and the law allows the taxable supply to be made in the future.

Section 38(3) of the GST Act provides the following:

"(3) Subject to subsections (4) and (5), where —

(a) no output tax is due at the end of any taxable period; or

(b) the amount of the credit entitled by virtue of subsection (1) to the taxable person exceeds the output tax,

the amount of the credit or the amount of credit that exceeds the output tax, as the case may be, shall be refunded to the taxable person by the Director General." (Emphasis added)

\textsuperscript{14} Time of supply rule can be found in s 11 of the GST Act
Section 38(3)(a) of the GST Act is a clear provision in which the law recognises that there may be situations where a taxable person will not have any output tax due at the end of a taxable period when a refund of input tax credit is claimed.

It is noted that s 38(7) of the GST Act allows the DG to impose conditions on the refund of input tax credit to a taxable person when no taxable supply has been made during a taxable period of any previous taxable period. However, this does not mean that the DG of Customs is allowed to reject any input tax refund rightfully entitled by the SPV. The wording of s 38(3) of the GST Act is clear that the input tax credit “shall” be refunded by the DG and that the entitlement to input tax should not be affected by when the output tax for that supply is to be made.

**Input tax entitlement for direct costs**

Pursuant to s 39(1)(a) of the GST Act, input tax for which any taxable person seeking to deduct shall be so much of the input tax for the period that is allowable and reasonable to be attributable to any taxable supplies made or to be made by the taxable person in the course or furtherance of his business.

Our courts have not considered what constitutes as an input tax attributable to taxable supply as provided in s 39(1)(a) of the GST Act. Reference can be made to the VAT case law in the UK where the relevant legislation of the input tax recovery is in pari materia with ss 38 and 39(1) of the Malaysian GST Act.

It is noted that the VAT case law in the UK has been influenced by the decision of the European Court of Justice (“ECJ”) to use the VAT Directives. It is observed that for the deduction of input tax, the right to deduct input tax under Art 17(2) of the EC Council Directive 77/388 (the Sixth Directive), which was brought into effect in the UK by ss 25 and 26 of the Value Added Tax Act 1994, is in turn in pari materia with ss 38 and 39(1) of the Malaysian GST Act, respectively. As such, the author’s view is that the principle adopted by the UK in the VAT case for deduction of input tax cases is of high relevance and persuasive to the Malaysian court.

In the UK, the test to determine whether an input tax credit is attributed to a taxable supply can be seen in *Mayflower Theatre Trust*\(^\text{15}\) and *Dial-a-Phone*.\(^\text{16}\) In both cases, the Court of Appeal of the UK applied the rationale of the ECJ in the celebrated case of *BLP*\(^\text{17}\) and *Midland Bank*\(^\text{18}\) to hold that an input tax is directly attributable to a given output tax if it had a “direct and immediate link” between the input cost in question and the supply or supplies in question. Alternatively, whether the input cost is a “cost component” of that supply or those supplies. In *Dial-a-Phone*, Jonathan Parker LJ held that there is no material difference between these alternative ways of expressing the basic test in the deduction of input tax to a taxable supply.

It is for the court to decide how to apply the direct and immediate link test of the facts of each test, taking into account all the surrounding circumstances. Applying the test to the input tax seeking to be deducted by a SPV, a SPV will be entitled to deduct the input tax if it is apparent that the input tax which the SPV is seeking to deduct in relation to the development project is a direct cost component to the taxable supply anticipated to be made after the completion of the development project.

The author’s view is that if the SPV can provide sufficient documents and information in relation to the output tax that will be generated upon completion of the development project, the Customs will have no basis to deny the input tax deduction sought by the SPV.

**Input tax entitlement for general business costs or overheads**

For general cost of business or overheads, it is observed that in the UK a taxable person has the right to deduct input tax credits where the input tax of the acquisitions is part of his general costs and is a component of the

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15 *Mayflower Theatre Trust Ltd v Revenue and Customs Comrs* [2007] EWCA Civ 116
16 *Dial-a-Phone Ltd v Customs and Excise Commissioners* [2004] EWCA Civ 603
17 *BLP Group Plc v Customs & Excise Comrs* (Case C-494), [1995] STC 424
18 *Midland Bank plc v Customs and Excise Comrs* (Case C-96/96), [2000] STC 501
price of the goods and services which the taxable person supplies. This principle is illustrated in *Investrand*, where the ECJ held that the existence of a direct and immediate link between a particular input transaction and a particular output transaction giving rise to an entitlement to deduct was, in principle, necessary before the taxable person was entitled to deduct input tax and in order to determine the extent of such entitlement. The right to deduct VAT charged on the acquisition of input goods or services presupposed that the expenditure incurred in acquiring them was a component of the cost of the output transactions giving rise to the right to deduct.

However, a taxable person has a right to deduct even where there was no direct and immediate link between a particular input transaction and an output transaction or transactions giving rise to the right to deduct, where the costs of the services in question are part of a taxable person’s general costs and are, as such, components of the price of the goods or services which he supplied. Such costs did have a direct and immediate link with the taxable person’s economic activity as a whole.

Applying the principle above, if the SPV is also making other existing taxable supplies, the input tax incurred on other taxable expenses by a SPV can be claimed as a general cost of business if these costs are part of the components of other taxable supplies made by the SPV. This is on the assumption that the SPV is a wholly taxable supplier; a mixed supplier will generally be required to apportion his general business costs/overheads by using the apportionment method prescribed under reg 39(4) of the GST Regulations.

Is Customs allowed to defer the input tax deduction or refund entitled by the SPV?

Based on s 38(4) of the GST Act, the whole or any part of input tax due as credit to any taxable person in any taxable period may be held over to be credited to any following or subsequent taxable period, either on the taxable person’s own application in writing or on any directions given by the DG. As such, the DG may give directions for input tax to be carried forward or to be credited on any following or subsequent taxable period pursuant to s 38(4) of the GST Act. In this regard, the author is of the view that such direction should only be given in most exception circumstances and in accordance with the spirit of the GST Act. It is important for a taxable person to be allowed to administer his business affairs and to regulate their cash flow accordingly. Any inherent discretion given under the GST law to the DG or Customs has to be exercised sparingly and in accordance with the spirit of the GST Act.

Arbitrary exercise of any inherent discretion by the DG or Customs would distort the principle of the GST system, which is based on the concept of tax neutrality and impose unnecessary burden to the business of a taxable person.

**Conclusion**

In conclusion, the author is of the view that the law does not require the corresponding output tax to be made in the taxable period when the input tax is deducted. An SPV in the above described circumstances should be entitled to deduct the input tax incurred for the project under ss 38 and 39 of the GST Act. However, the reader should bear in mind that the author’s views, analysis and arguments presented in this article have not been tested in the Malaysian court. It remains to be seen whether the present issue will be resolved by the court in favour of a taxable person.

**About the author**

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