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Court of Appeal Rules Feasibility Studies Expenses Are Tax Deductible

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In a recent decision, the Court of Appeal in *SSB v Ketua Pengarah Hasil Dalam Negeri* allowed the taxpayer's appeal, holding that feasibility study (FS) expenses are deductible under Section 33(1) of the Income Tax Act 1967 (ITA).

This decision provides authoritative guidance on the tax treatment of FS expenses. It affirms that such costs are deductible when incurred as part of a company's ongoing business operations, even if the parent company is the contracting party to the agreements.

The taxpayer was successfully represented by the firm's Tax, SST & Customs partner, S. Saravana Kumar together with associate, Tan Jass Key.

Background Facts

The taxpayer, a licensed electricity provider, was principally engaged in the generation, transmission, distribution, and sale of electricity. It was a wholly-owned subsidiary of SEB.

As part of its business operations, the taxpayer commissioned FS to evaluate the viability of potential hydroelectric projects. Independent consultants were engaged to prepare technical, financial, economic, and environmental reports. The taxpayer claimed deductions for these expenses under Section 33(1) of the ITA in its tax filings.

Following a tax audit, the Inland Revenue Board (Revenue) disallowed the tax deductions, taking the position that the FS expenses were capital in nature and therefore, prohibited under Section 39(1)(c) of the ITA. Despite the taxpayer's explanations, the Revenue maintained its position and the FS expenses incurred by the taxpayer in the years of assessment (YA) 2011 to 2020 amounting to nearly RM 200 million were disallowed.

Aggrieved by the Revenue's decision, the taxpayer appealed to the Special Commissioners of Income Tax (SCIT), which dismissed the taxpayer's appeals.

The High Court's Decision

On appeal, the High Court dismissed the taxpayer's case and held that the FS expenses were not deductible under Section 33(1) for the following reasons:

(a) The FS expenses were capital in nature and related to the acquisition of assets, and were therefore disallowed under Section 39(1)(c);

(b) The FS expenses had been incurred by SEB, not the taxpayer, as the agreements were entered into between SEB and the consultants; and

(c) The penalty imposed by the Revenue was correct in law.

Dissatisfied with the High Court's decision, the taxpayer appealed to the Court of Appeal.

Issue Before The Court Of Appeal

Whether the FS expenses incurred by the taxpayer for the YAs 2011 to 2020 were deductible under Section 33(1) of the ITA.

Taxpayer's Argument

The taxpayer submitted that the FS expenses were deductible on the following grounds:

(a) **FS expenses were revenue, not capital in nature**

(i) In *Ketua Pengarah Hasil Dalam Negeri v Shell Refining Company (FOM) Sdn Bhd* (2015) MSTC 30-106**,** the High Court upheld the SCIT's decision allowing deductions for FS expenses. The facts in *Shell Refining* were strikingly similar, as both involved consultants engaged to conduct FS to sustain and enhance ongoing business operations for the purpose of generating income.

(ii) The FS expenses were recurring in nature. As established in *Margaret Luping & Ors v Ketua Pengarah Hasil Dalam Negeri* [2000] 3 CLJ 409, which adopted *Vallambrosa Rubber Co Ltd v Farmer* 5 TC 529**,** income expenditure is expenditure that recurs annually. This was reflected in the taxpayer's consistent claims for the YAs 2011 to 2020 and corroborated by the Revenue's witness (RW), who admitted that FS were recurring expenses.

(iii) No capital asset was created. For instance, some of the dam projects were shelved and never built, as reported in the media. Furthermore, the audited accounts recorded no dam construction or enduring benefit arising from the FS expenses.

(iv) The correct test under Section 33(1), as clarified in *Aspac Lubricants (M) Sdn Bhd (formerly known as Castrol (M) Sdn Bhd) v Ketua Pengarah Hasil Dalam Negeri* [2017] 6 MLJ 65 and *Ketua Pengarah Hasil Dalam Negeri v Servier Malaysia Sdn Bhd* (2012) MSTC ¶30-038, is whether the dominant purpose of the expenditure is to generate business income.

Here, the FS were undertaken to assess the technical, financial, economic and environmental viability of projects for the production of electricity with a view to generating business income. The expenses were therefore revenue in nature.

(v) The principle articulated by the Supreme Court of Canada in *Bowater Power Company Limited v Minister of National Revenue* (1971) CTC 818 was persuasive. The court observed that:

> *"…merely because the expenditure was made for the purpose of determining whether to bring into existence a capital asset, it should not always be considered as a capital expenditure and, therefore, not deductible. In distinguishing between a capital payment and a payment on current account, regard must always be had to the business and commercial realities of the matter."*

Applying this reasoning, the FS expenses, though incurred to evaluate potential hydroelectric projects, formed part of the taxpayer's ongoing business operations and were properly deductible as revenue expenditure.

(b) **FS expenses were incurred by the taxpayer**

(i) The procurement of FS through SEB was driven by group-level considerations of centralisation, economies of scale and consistency in negotiations and branding. As confirmed by the taxpayer's witness (AW), SEB procured the services on behalf of the group, with the costs subsequently allocated to the taxpayer for its benefit.

(ii) The FS expenses were in fact incurred by the taxpayer. This was evidenced by the entries recorded in the SAP system, which clearly reflected the allocation of costs to the taxpayer. Notably, these entries were not disputed at trial.

(iii) In prior years, the Revenue had allowed deductions for donations under Section 44(6) of the ITA, even though the sponsorship agreements were entered into by SEB rather than the taxpayer. The inconsistent stance taken in the present appeal, where deductions were disallowed because SEB was the contracting party, was therefore untenable.

(c) **Penalty under Section 113(2) was unjustified**

The taxpayer relied on *Etiqa Family Takaful Berhad (formerly known as Etiqa Takaful Berhad) v Ketua Pengarah Hasil Dalam Negeri* (2024) MSTC 30-768, where the Court of Appeal held that differences in technical interpretation and reliance on professional advice do not amount to negligence. This was consistent with the testimonies of both AW and RW, and demonstrated that the imposition of penalty was unwarranted.

The Revenue's Argument

The Revenue submitted that the FS expenses were not deductible for the following reasons:

(a) Relying on *British Insulated and Helsby Cables Ltd v Atherton* [1926] AC 213, FS expenses were capital in nature when directed towards creating new business ventures and conferring enduring benefits. *Shell Refining* was said to be distinguishable, as the FS expenses in that case were incurred to sustain existing operations, whereas the present FS were undertaken to generate new income streams through hydroelectric projects.

(b) The FS agreements were executed by SEB and not the taxpayer. Accordingly, the liability to incur the expenditure did not fall within Section 33(1) of the ITA in relation to the taxpayer.

(c) The taxpayer could not rely on the definition of "successor" as SEB continued to exist as a legal entity. An analogy was drawn with *Woolley Development Sdn Bhd v Tiara Contours Construction Sdn Bhd* [2016] 2 MLJ 861, where the Court of Appeal held that a non-party cannot enforce or be bound by a settlement agreement. Applying this principle, the taxpayer, being a stranger to the FS agreements, could not step into SEB's shoes and claim deductions.

(d) The absence of any capital asset in the taxpayer's accounts was irrelevant. Reliance was placed on *Heather (Inspector of Taxes) v P-E Consulting Group Ltd* [1973] 1 All ER 8, it was argued that the classification of expenditure as capital or revenue is a question of law rather than accounting treatment.

(e) The imposition of penalties under Section 113(2) of the ITA was justified. Reference was made to *Syarikat Ibraco-Peremba Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* [2017] 2 MLJ 120, which affirmed that penalties under Section 113(2) are enforceable irrespective of good faith.

The Court of Appeal's Decision

The Court of Appeal unanimously reversed the High Court and SCIT decisions and held that:

(a) The FS expenses were deductible under Section 33(1) of the ITA. They were outgoings incurred on a yearly and recurring basis, revenue in nature and not capital. The dominant purpose of the FS was to assess the financial viability of the sites for planning dam projects, rather than for construction.

(b) The taxpayer was the permitted assignee of SEB in respect of the FS expenses. Accordingly, the expenses properly fell on the taxpayer.

(c) The penalty imposed under Section 113(2) was unjustified and was therefore set aside.

Conclusion

This decision affirms that FS expenses, when incurred as part of ongoing business operations, are deductible under Section 33(1) of the ITA. The Court emphasised that the dominant purpose test, rather than a rigid capital-versus-revenue distinction is the correct legal approach. It also clarified that such expenses may be deducted by a subsidiary when the costs are properly assigned, even if the parent company is the contracting party.

This ruling also offers significant clarity for businesses undertaking exploratory or preparatory studies, and confirms that penalties under Section 113(2) should not be imposed where disputes arise from reasonable differences in legal interpretation.

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