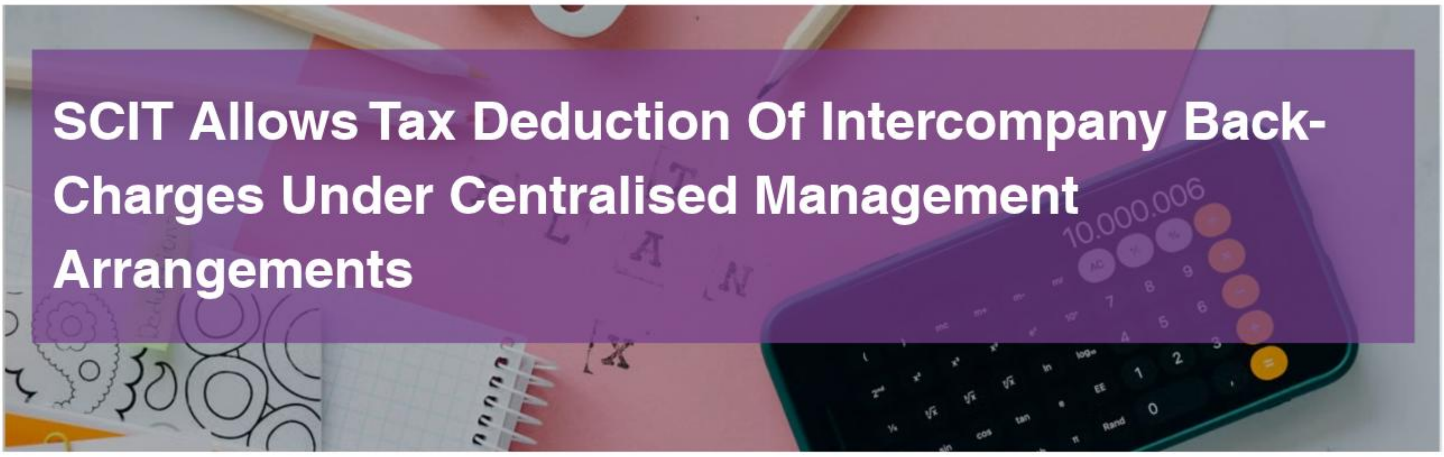
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SCIT Allows Tax Deduction Of Intercompany Back-Charges Under Centralised Management Arrangements

3 November 2026

For more information, please contact:

Datuk D P Naban
naban@rdslawpartners.com

S. Saravana Kumar
sara@rdslawpartners.com

Amira Azhar
amira@rdslawpartners.com

The Special Commissioners of Income Tax (SCIT) in *M12 SB v Ketua Pengarah Hasil Dalam Negeri* recently allowed the taxpayer's claim for tax deductions in relation to an increasingly common feature of modern corporate structures: the centralisation of management and operational functions within a single group company, with the corresponding expenses subsequently allocated and back-charged to other companies within the group.

In particular, the dispute concerned whether the Inland Revenue Board (Revenue) was justified in disallowing such expenses under Section 33(1) of the Income Tax Act 1967 (ITA) on the basis that the underlying contracts, invoices and employment records were maintained in the names of other group companies rather than the taxpayer.

The taxpayer was successfully represented by the firm's Tax, SST & Customs Partner, S. Saravana Kumar and Associate, Tan Jia Hua.

Background Facts

The taxpayer was principally engaged in the business of subcontracting ready-mixed concrete operations and formed part of a group of companies which adopted a centralised management structure.

Under this arrangement, a related company (Management Company) undertook various administrative and operational functions on behalf of the group, including securing operational sites, entering into tenancy agreements, recruiting workers, administering payroll and settling operational expenses.

The expenses were initially paid by the Management Company and subsequently allocated and back-charged to the respective group companies based on their operations.

For the years of assessment (YAs) 2016 to 2018, the taxpayer claimed deductions for site rentals, water and electricity charges, and staff costs including salaries, bonuses, as well as Employees Provident Fund (EPF) and Social Security Organisation (SOCSO) contributions.

Following a tax audit, the Revenue disallowed those deductions on the grounds that the underlying tenancy agreements, utility bills and employment records were maintained in the names of the Management Company or other parties, rather than the taxpayer. The Revenue further questioned the absence of formal written intercompany agreements and raised concerns over potential double deductions within the group.

Aggrieved by the Revenue's position, the taxpayer filed an appeal to the SCIT.

The Main Issue Before The SCIT

The central issue before the SCIT was whether expenses initially incurred or paid by the Management Company which were allocated and back-charged to the Taxpayer, were deductible under Section 33(1).

Specifically, the question was whether the taxpayer must itself be the named contracting party, utility account holder or legal employer, or whether deductibility could be established by demonstrating that the expenses were incurred in the production of its gross income and ultimately borne by it.

The Revenue's Arguments

The Revenue contended that the taxpayer had failed to establish that the disputed expenses were incurred by it within the meaning of Section 33(1).

First, in respect of site rental expenses, the Revenue disallowed deductions relating to four batching plants operated by the taxpayer, namely Batu Caves, Jalan Kebun, Rawang 2 and Kemuning Utama, on distinct grounds.

For the Batu Caves Plant, the Revenue questioned the validity of the tenancy arrangement because the landlord was not the registered proprietor of the land. It further relied on the fact that the tenancy agreement and subsequent novation were entered into by the Management Company rather than the taxpayer, as well as the landlord's winding-up proceedings, to dispute the validity of the rental arrangements and the taxpayer's entitlement to the deductions.

For the Jalan Kebun Plant, the Revenue challenged the sufficiency of the supporting tenancy and payment documents including deficiencies concerning the underlying landlord arrangements and questioned whether the rental expenditure had been incurred by the taxpayer.

For the Rawang 2 Plant, the Revenue relied, among other matters, on the fact that the landlord had treated the corresponding rental receipts as capital in nature. On that basis, the Revenue questioned the deductibility of the rental expenses claimed by the taxpayer.

For the Kemuning Utama Plant, the Revenue disallowed the rental expenses on the basis that the land was allegedly classified as agricultural land, notwithstanding its use by the taxpayer for batching plant operations.

The Revenue also challenged the letters of assignment relied upon by the taxpayer, contending that they were internal documents which had not been stamped or acknowledged or consented to by the respective landlords. Accordingly, the Revenue maintained that the taxpayer had failed to establish that the rental liabilities were legally incurred by it within the meaning of Section 33(1).

Second, in respect of water and electricity expenses, the Revenue maintained that the expenses were not deductible because the utility accounts and supporting bills were registered in the names of the Management Company, landlords or other related companies.

Third, the Revenue contended that the staff costs were incurred by the Management Company, which was the legal employer responsible for recruiting workers, administering payroll and making statutory contributions.

The Revenue further relied on the absence of written management, cost-sharing or back-charge agreements to question whether the taxpayer had assumed the corresponding liabilities.

Additionally, the Revenue raised concerns that the same expenses might have been claimed as deductions by both the Management Company and the taxpayer, resulting in double deductions within the group.

In essence, the Revenue maintained that the mere allocation or reimbursement of expenses between related companies did not establish that the statutory requirements for deductibility under Section 33(1) of the ITA had been satisfied.

The Taxpayer's Arguments

The taxpayer submitted that Section 33(1) does not require expenses to be contracted for or paid directly by the taxpayer, provided that they were wholly and exclusively incurred in the production of its gross income by the taxpayer. Neither does the provision expressly require formal written intercompany agreements as a prerequisite for deductibility.

In respect of site rental expenses, the taxpayer relied on the tenancy agreements, letters of assignment, payment records and general ledgers to establish that the disputed premises were used for its batching plant operations and that the corresponding rental expenses were ultimately borne by it.

The taxpayer further argued that the Revenue's objections concerning the landlords' ownership, winding-up status, tax treatment of rental receipts and land classification did not, in themselves, determine the deductibility of the expenses under Section 33(1).

As regards water and electricity expenses, the taxpayer maintained that the utility charges were attributable to its business operations and were duly allocated and back-charged through debit notes, tax invoices and corresponding accounting entries, notwithstanding that the utility accounts were registered in the names of other parties.

In relation to staff costs, the taxpayer explained that the Management Company centrally employed and administered workers deployed to the Taxpayer's operations. The corresponding salaries, bonuses and statutory contributions were subsequently allocated and back-charged to the taxpayer, as reflected in the respective accounting records.

Importantly, during cross-examination, the Revenue's witness acknowledged that the Taxpayer had furnished documentary evidence of the intercompany back-charges and that no actual instance of double deduction had been identified.

Accordingly, the taxpayer maintained that the Revenue had wrongly prioritised the form of the underlying contractual arrangements over the commercial substance of the expenses, which were incurred and ultimately borne by the taxpayer in the production of its gross income.

The SCIT Ruling

The SCIT allowed the taxpayer’s appeal.

This decision is significant for businesses adopting centralised management and shared-services arrangements, particularly where operational expenses are initially paid by one group company and subsequently allocated and back-charged to others.

For taxpayers operating under similar arrangements, clear intercompany cost allocations, contemporaneous supporting documents and consistent accounting treatment remain essential in substantiating deductions under Section 33(1). While formal intercompany agreements are not expressly prescribed by Section 33(1), maintaining such agreements may help establish the basis upon which expenses are allocated and liabilities assumed.

Ultimately, the deductibility of intercompany back-charges must be assessed by reference to the statutory requirements of Section 33(1) and the evidence supporting the expenditure, rather than solely by the identity of the original contracting party.

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KUALA LUMPUR
Level 16, Menara 1 Dutamas No. 1, Jalan Dutamas 1, Solaris Dutamas, 50480 Kuala Lumpur
T: +603 6209 5400
F: +603 6209 5411
enquiry@rdslawpartners.com

PENANG
Suite S-21E & F21st Floor, Menara Northam, No. 55, Jalan Sultan Ahmad Shah, 10050 Penang
T: +604 370 1122
F: +604 370 5678
generalpg@rdslawpartners.com

JOHOR BAHRU
8-35, Menara Delima Satu, Jalan Forest City 1, Pulau Satu, 81550 Gelang Patah, Johor Bahru
T: +607 585 6414
F: +607 509 7614
generaljb@rdslawpartners.com