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High Court Affirms Taxpayer's Eligibility To Claim Industrial Building Allowance

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Industrial building allowance (IBA) is a form of tax relief available to a taxpayer who has in a year of assessment (YA) incurred qualifying expenditure for the construction or purchase of a building considered to be an industrial building.

In the recent case of *Ketua Pengarah Hasil Dalam Negeri v Classic Japan (M) Sdn Bhd & Another Appeal*, the High Court laid down the fundamental principles in determining a taxpayer's eligibility to claim for IBA.

Our Tax, SST & Customs partner, S. Saravana Kumar had previously represented the taxpayer before the Special Commissioners of Income Tax (SCIT), where he successfully won the IBA claim for the taxpayer.

Brief Facts

The taxpayer is a company involved in collecting, processing, and shipment of flower cutting for export. The taxpayer claimed IBA on the capital expenditure incurred for the construction of its factory. The taxpayer's factory included a cold room facility where it was used to store the fresh flowers before exporting them to Japan.

Pursuant to a tax audit, the Director-General of Inland Revenue (DGIR) raised notices of additional assessment, among others, for disallowing the taxpayer's claim for industrial building allowance on the cold room facility. Aggrieved by the assessments, the taxpayer filed an appeal to the SCIT.

The SCIT agreed that the cold room facility was an industrial building within the meaning of paragraph 63 of Schedule 3 of the Income Tax Act 1967 (ITA) and allowed the taxpayer's appeal to claim IBA. The DGIR being dissatisfied with the SCIT's ruling appealed to the High Court.

REIMAGINING TAX SOLUTIONS

Relevant Statutory Provisions

The starting point for an IBA claim is under paragraph 3 of Schedule 3, which reads as follows:

> *"Subject to paragraph 6, qualifying building expenditure is capital expenditure incurred on the construction or purchase of a building which is used at any time after its construction or purchase, as the case may be, as an industrial building"*

Under paragraph 63 of Schedule 3, the term "industrial building" is defined as follows:

> "*Subject to paragraphs 64 to 66, a building is an industrial building within the meaning of this Schedule if it is used for the purposes of a business and – it is used as a factory..*"

The definition of "factory" can be found in paragraph 64 of Schedule 3, which provides that:

> *"In subparagraph 63(a) "factory" includes:*
>
> *(a) A building consisting of a mill, workshop (other than a workshop used for the repair or servicing of goods, if the repair or servicing is carried out in conjunction with or incidentally to the business of selling those goods) or other building for the house of machinery or plant of any description for the manufacture of any product or the subjection of goods or materials to any process or the generating of power used for the purposes of that manufacture or process…."*

The DGIR's Contention

At the High Court, the DGIR contended that the taxpayer failed to fulfil the conditions to claim IBA for the following reasons:

(a) In the absence of a definition for the word "process" in the ITA, the DGIR relied on the definition in the Cambridge Advanced Learner's Dictionary which provides that the word "process" is defined as "a method of producing goods in a factory by treating raw materials / a series of actions that produce something or that lead to a particular result."

(b) The taxpayer's activity does not constitute "process" on the following basis:

(i) The taxpayer is merely packaging the fresh flowers, which is not a "process".

(ii) The taxpayer's activity does not change the shape of the fresh flowers and does not increase the market value of the fresh flowers as being sold to Japan.

(iii) The taxpayer's activity does not produce something or lead to a particular result.

The Taxpayer's Submission

Similar to the arguments raised before the SCIT, the taxpayer maintained the position that the capital expenditure is a qualifying building expenditure by virtue of the following submissions:

(a) The word "includes" in paragraph 64 of Schedule 3 denotes that the definition of "factory" is inclusive rather than exhaustive. The High Court in the *Lavender Confectionery & Bakery Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* case held that:

> *"Firstly, the definition of factory under paragraph 64 is not exhaustive as the word 'includes' is used."*

As such, a building that does not come within paragraph 64 of Schedule 3 may still fall within the definition of "factory" for claiming the IBA.

(b) The DGIR erred in contending that the taxpayer's activity does not constitute "process." The DGIR's reliance on the *Kilmarnock Equitable Co-operative Society v IRC* case was erroneous as the taxpayer in *Kilmarnock* was allowed to claim for an IBA for capital expenditure incurred on a building where coal had been packaged and weighed.

(c) Based on the SCIT's fact findings, it was proven that the flowers had been subjected to a process such as inspection, trimming, grading, bunching and cutting, hydration, packing, and shipping which were all conducted in the taxpayer's factory. The packaging process was held to be a very important process, and in the absence of the aforementioned process, the flowers would not be able to last the journey to Japan. Therefore, there is a value-added to the processed and packaged flowers as they would be able to have a longer lifespan to survive the journey to Japan without damage.

(d) Alternatively, the taxpayer's factory falls within the ambit of paragraph 37C of Schedule 3, where the cold room at the taxpayer's factory is used solely for storing the processed fresh flowers.

The High Court's Decision

The High Court affirmed the SCIT's decision and held that the taxpayer's cold room facility satisfies the requirements to be an industrial building under paragraph 63 of Schedule 3. The High Court upheld the legal principles in the *Kilmarnock* case, whereby the repacking of the coal by retaining the original state qualifies as having been subjected to a process.

The High Court also accepted the alternative argument that the taxpayer was entitled to claim for IBA under paragraph 37C of Schedule 3, as the cold room facility formed a crucial and integral part of the building as it was "*used by a person solely for the purpose of storage of goods for export*."

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Commentary

This decision follows the earlier decision in the *Lavender Confectionery & Bakery Sdn Bhd* case where the High Court allowed the taxpayer's IBA claim for the capital expenditure incurred for the construction of a boundary around the factory complex, guardhouse and concrete driveway. The High Court held that the functionality test should be applied in determining whether the items claimed are necessary and integral to the functioning of the factory. The High Court's decision in the *Lavender Confectionery & Bakery Sdn Bhd* case was subsequently affirmed by the Court of Appeal.

Our Senior Partner, Datuk D.P. Naban and Tax, SST & Customs, Mr S. Saravana Kumar successfully represented the taxpayer in the *Lavender Confectionery & Bakery Sdn Bhd* case.

Authored by Yap Wen Hui, associate with the firm's Tax, SST & Custom practice.