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Tax Deductibility Of Forest Expenditure & Forest Allowance

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In view of the growing global demand for wood supply, timber harvesting has inevitably become more and more prominent. The timber and forest products industry value chain begins with standing timber in forests and extends to a variety of manufactured forest products. Huge costs would need to be incurred to extract and move the timbers from the woods to the mills. This raises the question whether expenditure such as the construction costs of linking roads and living accommodations are deductible under Section 33(1) of the Income Tax Act 1967 (ITA).

Deductibility Of Forest Expenditure Under Section 33(1) Of The ITA

As a general rule, expenditure incurred in the course of business is deductible if it falls under Section 33(1). The Court of Appeal in *Aspac Lubricants (Malaysia) Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* [2007] 5 CLJ 353 held that Section 33(1) is a “basket provision” supporting deduction of all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of gross income, provided that the deduction is not prohibited by Section 39(1) of the ITA.

Based on the conjunctive reading of both Section 33(1) and Section 39(1)(e), which reads as follows:

“39(1) Subject to any express provision of this Act, in ascertaining the adjusted income of any person from any source for the basis period for a year of assessment no deduction from the gross income from that source for that period shall be allowed in respect of—

(e) any expenditure incurred in relation to a business, being expenditure which is—

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(ii) *qualifying expenditure, qualifying agriculture expenditure or qualifying forest expenditure for the purposes of Schedule 3; or...*

the forest expenditure clearly does not qualify for a deduction under Section 33(1) of the ITA.

In support of this legal position, paragraph 8 of Schedule 3 of the ITA reiterates that a qualifying forest expenditure for the purposes of this Schedule is capital expenditure. For the purposes of Schedule 3 of the ITA, a qualifying forest expenditure includes the construction costs of:

- (a) A road or building used for the purposes of a business of a taxpayer which consists wholly or partly of the extraction of timber from the forest.
- (b) A building provided by a taxpayer for the welfare of persons, or as living accommodation for a person, employed in or in connection with such extraction.

Pursuant to the unambiguous wordings in the ITA, it is evident that a qualifying forest expenditure is not deductible under Section 33(1). This legal position has been made clear by the High Court in *Ketua Pengarah Hasil Dalam Negeri v Primary Properties Sdn Bhd* (2009) MSTC 4,383.

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The taxpayer in *Primary Properties* was a company actively involved in the logging business. It entered into an extraction agreement with its main contractor to fell and exact timber logs in designated forest areas. In order to extract timber from the forested areas, the taxpayer had constructed linking roads to allow the entry of its heavy machinery and built camps for its workers to stay. Subsequently, the taxpayer claimed a tax deduction on the costs incurred under Section 33(1).

The High Court affirmed the decision of the Special Commissioners of Income Tax in disallowing the deduction of the construction costs of the temporary logging roads and workers' camps under Section 33(1) on the premise that those expenses were capital in nature. Whilst the construction of logging roads and workers' camps were essential pre-requisites to any timber extraction business, those costs had the nature of being "once and for all" expenditure essential to the start of the operation of the timber extraction business,

without which the business would not be viable. The treatment of such costs as being capital in nature was supported by paragraphs 8(1)(a) and 8(1)(b) of Schedule 3 of the ITA as well.

In *Coltness Iron Co v Black (Surveyor of Taxes)* TC 287 and *Ounsworth v Vickers, Ltd* [1915] 3 KB 267, the expense of sinking pits in a coal mine and the expense of deepening a channel by a shipbuilding firm were held to be capital expenditures. An analogy was drawn between the road and workers' camp with the sinking pits and the deepening channels, which were not only advantages but downright essential to the timber extraction business.

However, despite that the deduction was disallowed under Section 33(1), the taxpayer was not left without remedy. The High Court in *Primary Properties* referred to paragraph 8 of Schedule 3 and held that the taxpayer, as the beneficial owner, was entitled to forest allowance.

Forest Allowance – Eligibility To Claim And Computation

At the outset, “forest” in relation to a person, means a forest in respect of which he has a concession or a licence to extract timber therefrom. This legal position has been affirmed by the Federal Court in *River Estates Sdn Bhd v Director General of Inland Revenue* [1981] 1 MLJ 99 where the court held that “*In the same way a person, engaged in carrying on a business which consists wholly or partly of the extraction of timber under a concession or licence, is entitled to claim a capital allowance called “forest allowance”.*”

According to paragraphs 30(a) and 30(b) of Schedule 3 of the ITA and as per the Inland Revenue Board’s policy as per paragraph 4.1 of the Forest Allowances and Expenses Relating to Timber Extraction (Public Ruling No. 11/2014), the rate of allowance for the construction of roads or buildings which are used for the purposes of the business of extracting timber is 10% of the expenditure incurred. As a concession, bridges or jetties constructed for such business would also qualify for the allowances specified. The rate of allowance for the construction of buildings provided for the purposes of welfare or living accommodation of employees engaged in the extraction of timber is 20% of the expenditure incurred.

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The grant of forest allowance is subject to the condition laid down in paragraph 8 of Schedule 3 of the ITA. In order to qualify for the forest allowance, the roads or buildings constructed in the forest shall be of little or no value to any person if the activity of timber extraction ceases. It shall be noted that a logging contractor who does not hold a licence or concession is not entitled to claim forest allowance even if he had incurred qualifying forest expenditure and may have made payments to the holder of the concession or licence for the right to extract timber from the forest.

However, the royalty or premium paid by the logging contractor to the State Government in the name of the licence-holder and the payment made to the license-holder for the purchase of timber are deductible expenses under Section 33(1) as they are expenditure incurred wholly and exclusively in the production of the logging contractor's income. In most cases, the licence fee and the survey and demarcation fees paid to any Forest Department are considered as revenue expenditure and are deductible under the same provision.

Tax Treatment Upon The Cessation Of Timber Extraction Business And Disposal Of Forest

In the long run, the forest resources are foreseeable to face an exhaustion and the logging activities on a particular piece of land will be brought to cessation. As a general rule, a person is not entitled to claim any forest allowance after the business has ceased. Hence, the tax treatment upon the cessation of timber extraction business and disposal of forest warrants a discussion to secure the taxpayer's interest.

Pursuant to paragraph 31 of Schedule 3 of the ITA, an allowance equal to the balance of the capital expenditure which has not been given is allowed to be deducted in the year of cessation.

On the other hand, in reference to paragraph 32(1) of Schedule 3, where a person who has incurred qualifying forest expenditure disposes of that forest, a forest charge shall be made to him in the year of disposal. The amount of forest charge is equivalent to the amount of forest allowances made to him for each year of assessment and on permanent cessation of the business of extracting timber. For the purpose

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of computing forest charge, the actual sale consideration received or receivable by the person is not taken into account.

Conclusion

In gist, forest expenditure incurred by a person who has a concession or a licence to extract timber is not deductible under Section 33(1) read together with Section 39(1)(e). However, paragraph 8 of Schedule 3 watered down the rigidity of the restriction by providing an alternative incentive, namely the forest allowance. This is a much welcomed tax incentive that should be brought to the awareness of the public and be fully utilised to the advantage of taxpayers.

Authored by Tan Jia Hua, Pupil-in-Chambers from the firm's Tax, SST and Customs department.

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