Technical Group Discussion

Decoding Capital Allowances

5 December 2011, Monday

Accredited Tax Advisor (Income Tax) Mr Leung Yew Kwong shared his valuable insights on the recent case ATG v Comptroller of Income with the participants.

In the recent fully subscribed technical discussion facilitated by Mr Leung Yew Kwong, Accredited Tax Advisor (Income Tax) and Partner at WongPartnership LLP, he shed light on the recent case of *ATG v Comptroller of Income Tax* by explaining the facts and circumstances that led to the Board of Review's decision on ATG's claim for capital allowances.

Brief summary of *ATG v Comptroller of Income Tax*

ATG ("the Appellant") is a manufacturing company that outsources parts of its manufacturing operations to independent sub-contractors. During the financial years 2002 and 2003, the Appellant's "buy/sell" business arrangement with its sub-contractors provided that the sub-contractors would manufacture the products in part of the manufacturing chain and on-sell the manufactured products to the Appellant. In addition, the Appellant would also place certain plant and machinery at the sub-contractors' premises for the purpose of manufacturing these products.

The Comptroller of Income Tax ("the Respondent") disallowed the Appellant's claim for capital allowances under Sections 19 and 19A of the Income Tax Act ("ITA") on the capital expenditure incurred for plant and machinery placed at the premises of the sub-contractors as:

- ownership and associated risks of the manufacturing process laid ultimately with the sub-contractors;
- ownership (i.e. risk and rewards) of the manufactured goods laid with the sub-contractors until sold to the Appellant; and

- the sub-contractors were responsible for the upkeep of the equipment (including bearing maintenance and repair costs).

In view of the above, the Respondent was of the opinion that the purpose and use of the plant and machinery was for the separate trade of the sub-contractors (and not that of the Appellant), and that capital allowances could not be granted to the Appellant.

Key Considerations Discussed

Mr Leung brought up several key issues put forth during the hearing of *ATG v the Comptroller of Income* and they include the following:

Toll manufacturing vs contract manufacturing (i.e. "buy/sell" arrangement)

A typical toll manufacturer uses the taxpayer's plant or machinery to manufacture goods for the taxpayer for a fee. The toll manufacturer does not own any raw materials or manufactured goods. As such, the ownership and risk of the raw materials and manufactured goods remain with the taxpayer (and not passed to the toll manufacturer).

On the other hand, in a "buy-sell" model, the taxpayer sells the materials to the contract manufacturer. The contract manufacturer uses the taxpayer's plant or machinery to manufacture goods and re-sells the manufactured goods back to the taxpayer. Hence, the ownership and risk of the goods lie with the contract manufacturer until the goods are re-sold to the taxpayer.

The Respondent had the notion that the contract manufacturer uses the taxpayer's plant or machinery for the contractor's separate trade in the buy/sell model, such that the taxpayer was no longer using the plant for his own trade. On the basis of this notion, the Respondent denied the capital allowances under Section 19 and 19A of the ITA.

Mr Leung explained that the risk and ownership of raw materials and manufactured goods was not a qualifying condition that needed to be satisfied to claim capital allowances under Sections 19 and 19A of ITA.

As such, whilst the ownership and risks of the raw materials and the manufactured goods may be borne by the sub-contractors, the Appellant should be allowed to claim for capital allowances.

Interpretation of Sections 19 and 19A of the ITA

Certain words such as "use", trade" and "for the purpose of ... trade" stated in Sections 19(2) and 19A(1) of the ITA were analysed. It was identified from the scrutiny of Sections 19 and 19A of the ITA that another issue of contention in the present case was the degree of connection between the Appellant's business and the use of the plant and machinery placed with the sub-contractors.

Contrasting Sections 19(2) and 19A(1) with the provisions in Sections 19(8), 19A(14B), 14(1) and 14D(1) of the ITA, it was noted that the former sections did not include words like "exclusively" or "directly". Accordingly, it appeared that the Appellant was not required to use the plant and machinery exclusively or directly.

As such, although the sub-contractors had "operated" the plant and machinery, the plant and machinery were still used for the purpose of the Appellant's business and thus, capital allowances should be allowed.

Applicability of Integrated Industrial Capital Allowance ("IICA") scheme

The Respondent also contended against granting the capital allowances on plant and machinery under Sections 19 and 19A of the ITA in the present case on the argument that the introduction of the IICA scheme and Sections 97ZB and 97ZC of the Economic Expansion Incentives (Relief from Income Tax) Act ("EEIA") would otherwise be redundant.

The transactions contemplated under Sections 97ZB and 97ZC of the EEIA are projects using an overseas subsidiary. These provisions did not overlap entirely with those in Sections 19 and 19A of the ITA. Therefore, Sections 97ZB and 97ZC of the EEIA should not have the effect of restricting the application of Sections 19 and 19A of the ITA, in the absence of clear words to the contrary.

Conclusion

The Respondent had made a distinction in capital allowances treatment for toll manufacturing and contract manufacturing on the basis of the ownership of the goods while the goods are being produced. However, the different treatment in the grant of capital allowances based on this distinction was not supported by the statutory language.

The Appellant had incurred capital expenditure on the plant and machinery and placed them with the third party sub-contractors, as one of its business strategies was to outsource lower value-added work to independent third parties while retaining the higher value-added work, in order to be cost-effective.

Such a cost-effective measure was intended to generate more profits for taxpayer's business which were subsequently subjected to Singapore tax.

As such, it was concluded that the plant and machinery were indeed used for the purpose of Appellant's trade or business and contributed to Appellant's profits, and capital allowances were to be granted accordingly.

The Board of Review had ruled in favour of the Appellant in the present case.

The session came to a close with a final word of advice from Mr Leung to "always come back to the words of the statutes" when considering the tax implications of each case.

A big thank you to Mr Leung Yew Kwong for the enriching presentation and interesting discussion!