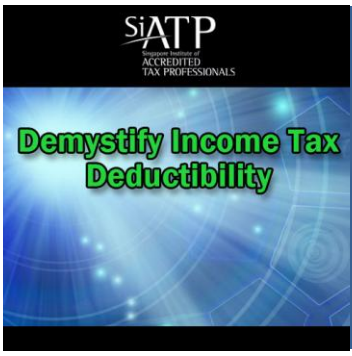

TED: Demystify Income Tax Deductibility

Get a Firm Grip on Tax Deductibility and Prohibitions

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Facilitated by:
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Business expenses may either be deductible or non-deductible for income tax purposes. Deductible business expenses can reduce a taxpayer's taxable income, lowering its income tax payable. As such, getting a firm grip on sections 14 and 15 of the Income Tax Act (ITA), which govern the deductibility and prohibitions against certain business expenses, is important to a taxpayer.

Conversely, if the taxpayer is unfamiliar with such tax rules, it may under-claim eligible tax deductions or over-claim tax deductions without legal basis, resulting in a higher tax payable or even penalties for the taxpayer.

At a recent *Tax Excellence Decoded* session organised by the Singapore Institute of Accredited Tax Professionals, Liu Hern Kuan, tax lawyer at Tan Peng Chin LLC, shared his insights on key deductibility issues enunciated in notable tax cases he was personally involved in, such as *JD v CIT* [2005], *T Ltd v CIT* [2006] and *IA v CIT* [2006], as well as developments in interest deductibility issues following these cases.

Deductibility And Prohibitions

Singapore's legal basis on deductibility and prohibitions against business expenses are provided in sections 14 and 15 of the ITA.

Section 14

Section 14(1) provides the general deduction formula. Expenses that fulfil the conditions are deductible for income tax purposes. The deduction formula is:

> "… there shall be deducted all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of the income, including…"

Section 14 also contains specific deduction provisions under sections 14(1)(a) to (h), which specifically allow tax deduction for certain expenses (that would not normally qualify under the general deduction formula), and sections 14A to 14ZB, which provide for deduction for various tax incentives or special treatment.

The word, "including" in section 14(1) suggests that the specific deductions in sections 14(1)(a) to (h) are not subject to the requirements in the deduction formula above.

Liu Hern Kuan, tax lawyer at Tan Peng Chin LLC, shared his insights on key tax deductibility issues enunciated in recent tax cases.

SECTION 15

Unlike section 14, section 15 prescribes a negative test on deductibility. Theoretically, expenses caught under section 15 would not be deductible even though they may satisfy the general deduction formula under section 14(1). Section 15(1) states that:

> "Notwithstanding the provisions of this Act, for the purpose of ascertaining the income of any persons, no deduction shall be allowed in respect of…" (emphasis added)

The sentence "notwithstanding the provisions of this Act" would seem to suggest that section 15 would take precedence over section 14, but the question remains on how an expense should be treated if it is both specifically allowed and disallowed under sections 14(1)(a) to (h) and 15 respectively.

Interaction Between Sections 14, 14(1)(a) And 15(1)(c)

The answer to this question can be found in several Singapore tax cases that dealt with the interaction between sections 14, 14(1)(a) and 15(1)(c) on the deductibility of borrowing costs, including *T Ltd v CIT* [2006], *IA v CIT* [2006] and *BFC v CIT* [2014]. The leading case on borrowing expenses is the Court of Appeal case of *BFC v CIT* [2014]:

BFC v CIT [2014]

The taxpayer, BFC, was in the business of hospitality, investment holding and property investment. It also owned and operated a hotel.

BFC issued bonds in 1995 and 1996. Each bond issue was for a five-year term and was issued at a discount. In addition, the bonds issued in 1995 also carried a premium on redemption.

The CIT did not dispute the taxpayer's deduction claim on its interest expenses, but disallowed its claim on the discounts and redemption premiums. After unsuccessful appeals to the Income Tax Board of Review (ITBR) and the Singapore High Court (SGHC) respectively, BFC further appealed to the highest court in Singapore, the Court of Appeal (CA).

The ultimate question was whether the discounts and redemption premiums were tax deductible. In arriving at the conclusion, the CA set out the order of its analysis of the relevant issues:

i. Whether the discounts and redemption premiums were capital expenditure and therefore prohibited from deduction under section 15(1)(c);

ii. Whether the discounts and redemption premiums were "outgoings and expenses wholly and exclusively incurred" in the production of income in the context of section 14(1), and

iii. Whether the discounts and redemption premiums were "interest" under section 14(1)(a).

ANALYTICAL FRAMEWORK

The CA chose to first address whether the discounts and redemption premium were prohibited from deduction under Section 15(1)(c), as its determination could make it unnecessary to consider the second issue. In addressing the first issue, the CA endorsed the analytical framework laid down in earlier decisions in *T Ltd v CIT* [2006] and *IA v CIT* [2006] to determine whether expenses incurred in connection with a loan is revenue or capital in nature.

Essentially, the nature of borrowing costs is derived from the nature of the underlying loan, which in turn depends on the purpose of the loan. So if a loan is taken for the purpose of acquiring or enhancing the permanent structure of a business (for example, if the loan is taken to purchase capital asset such as land or machinery), it is capital in nature. However, if the loan is taken to acquire trading stock, it is revenue in nature.

It should also be noted that the sole purpose of the loan is to be assumed as capital in nature if there is insufficient linkage between the loan and the transaction for which the loan is taken (for example, if the loan is taken up without any stipulation as to what it is to be used for).

THE CA'S ANALYSIS AND DECISION

BFC issued the bonds for three purposes – first, to finance the renovation of the hotel (which is a capital asset); second, to refinance the existing borrowing (which is assumed to be capital in nature due to lack of information on the purpose of the existing loans), and third, as working capital for its day-to-day operations (which is assumed to be capital in nature since it is taken without stipulation as to what the loan was to be used for). As the bonds were issued for capital purposes, the discounts and redemption premiums in respect of the bonds should likewise be regarded as capital expenditure under section 15(1)(c).

Since section 15(1)(c) applies, it was unnecessary to consider the second issue as section 15 takes precedence to the general deduction formula under section 14(1). The issue then was whether the discounts and redemption premiums were "interest" under section 14(1)(a), a specific deduction provision.

Being a specific deduction provision, the CA adopted a less liberal interpretation of the term "interest" under section 14(1)(a). Notwithstanding that discounts and redemption premiums may have the same economic effect as interests, the CA opined that the discounts and redemption premiums were not "interest" under section 14(1)(a) on the basis they do not bear the fundamental feature of accrual with time (as with interest). As such, the CA held that section 14(1)(a) does not apply in this case and the discounts and redemption premiums were not tax deductible.

The order of analysis set out by the CA affirmed that section 14(1)(a) is an exception to section 15(1)(c). The same view was held in subsequent tax cases such as *GBK v CIT* [2016].

GBK v CIT [2016]

The taxpayer, GBK, was in the business of owning and operating a mall. In 2004, it assigned its rights to the rental income from the mall to a special purpose vehicle as security for a loan. Thereupon, the taxpayer issued bonds to shareholders and returned capital to shareholders. GBK's deduction claim on the interest expenses incurred on the bonds to shareholders was disallowed by the CIT on the basis that that the interest is capital expenditure. GBK appealed to the ITBR.

The issue before the ITBR was whether there was a direct link between the rental income and the interest expense.

Liu Hern Kuan, tax lawyer at Tan Peng Chin LLC, answering participants' queries during the session.

On the basis that the mall was already generating sufficient rental income to operate prior to the securitisation transaction, and as the capital restructuring exercise was undertaken as a result of the abolition of the imputation system to allow shareholders to obtain a return in the form of interest and not for the purpose of deriving income, the ITBR upheld the CIT's decision (that the interest was non-deductible) as it was unable to find any "direct link" between the interest expense and rental income for section 14(1)(a) purposes.

Subsequent to the session, on 5 June 2017, the High Court issued a judgement (*BML v CIT* [2017] SGHC 118) affirming the ITBR's decision that the interest was not deductible.

When determining whether an expense is deductible for income tax purposes, one should first look at the prohibitions under section 15 of the ITA, followed by specific deduction provisions under section 14(1)(a) to (h), which are exceptions to the prohibitions. If the expense does not fall under either, one should then look at whether it may qualify for tax deduction under the general deduction formula in section 14(1) of the ITA. Section 14(1)(a) is also an exception to section 15(1)(c); in other words, even though interest payable on capital employed in acquiring the income is capital, the interest may be deductible under section 14(1)(a).

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