Deloitte.

28th SEA GAMES

OFFICIAL PROFESSIONAL SERVICES PARTNER

Singapore | Corporate Tax | 26 Sept 2014

Corporate Tax Alert

Stay informed of new developments

Greetings from your tax team at Deloitte Singapore. We are pleased to enclose for your information the latest Deloitte Tax Alert on:

BFC v Comptroller of Income Tax

On 25 July 2014, the Singapore Court of Appeal (SGCA) issued a decision concerning whether the discounts given and redemption premium paid by an issuer of bonds are regarded as "interest" for the purposes of deduction under section 14 and 14(1)(a)[1] of the Singapore Income Tax Act (ITA). The SGCA also clarified how the provisions of section 15(1)(c)[2] are to be read in conjunction with the provisions of section 14 and 14(1)(a).

Facts of the case

• The Appellant, BFC, carries on the business of hospitality, investment holding and property investment. BFC also owns and operates a hotel (the "Hotel").

• BFC issued bonds in 1995 and 1996. Each bond issue was for a five year term and matured in 2000 (YA 2001) and 2001 (YA 2002) respectively. The bond issues may be summarised as follows:

	Principal amount	Discount	Redemption Premium	Usage of bond proceeds

1995 Bonds (5.625% p.a.)	$150 million	$645,750	$2,250,000	• Financing the renovation of the Hotel • Refinancing of existing borrowings • Working capital
1996 Bonds (5.75% p.a.)	$165 million	$11,682,495	-	• Refinancing of existing borrowings

• The Inland Revenue Authority of Singapore (IRAS) allowed tax deduction on coupon interest on the 1995 Bonds in proportion to the quantum of bond proceeds utilised to finance the renovation of the Hotel. The balance of coupon interest (for both 1995 and 1996 Bonds) was allowed deduction insofar as it was attributable to income-producing assets.

• However, BFC's claim for tax deduction on the discounts and redemption premium realised in YA 2001 and YA 2002 on the aforementioned basis was denied by the IRAS.

Issues addressed

• On appeal by BFC, the following issues were examined by the Income Tax Board of Review (ITBR)[3] and the Singapore High Court (SGHC)[4]

i) Whether the discounts and redemption premium were "interest" under s14(1)(a);

ii) Whether the discounts and redemption premium were "outgoings and expenses wholly and exclusively incurred" in the production of income in the context of s14(1); and

iii) Whether the discounts and redemption premium relate to "any capital withdrawn or any sum employed or intended to be employed as capital" (i.e. capital expenditure) and therefore prohibited from deduction under s15(1)(c).

• The ITBR and SGHC ruled in favor[5] of the IRAS. BFC then appealed to SGCA.

Judgment of the SGCA

Whether discounts and redemption premium were capital expenditure and therefore prohibited from deduction under s15(1)(c)

The SGCA reversed the order of the analysis undertaken in the SGHC and started off with looking at whether the discounts and redemption premium were capital expenditure. This is on the basis that the determination of the s15(1)(c) issue will make it unnecessary to decide the s14(1) issue, and leave the most hotly contested issue of s14(1)(a) which is also the issue that BFC is most likely to succeed on, to the last.

The SGCA endorsed the analytical framework laid down in the decisions of T Ltd[6] and IA[7] to determine whether expenses incurred in connection with a loan is revenue or capital in nature.

Broadly, the analytical framework can be described as follows: -

• The nature of borrowing costs (whether capital or revenue) is derived from the nature of the underlying loan.

• In turn, the nature of the underlying loan depends on the purpose of the loan. A loan is capital in nature if it is taken for the purpose of acquiring or enlarging the permanent structure of a business (such as the purchase of land or machinery). On the other hand, a loan taken up to acquire trading stock would be regarded as revenue in nature.

• Before applying the above principles, there must be sufficient linkage or relationship between the loan and

the main transaction for which the loan is taken. If there is insufficient linkage or relationship (i.e. where the loan is taken out without any stipulation as to what the loan monies are to be used for), it must be assumed that the sole purpose of the loan is to add to the taxpayer's capital structure, and therefore the loan is prima facie capital in nature.

It was held[8] that the 1995 and 1996 Bonds were issued by BFC for capital purposes. As such, the discount and redemption premium in respect of the Bonds, being derivative in nature, were regarded as capital expenditure and s15(1)(c) applies to deny tax deduction on such expenditure.

Whether the discounts and redemption premium were "outgoings and expenses wholly and exclusively incurred" in the production of income in the context of s14(1)

Having determined that s15(1)(c) applies, the SGCA commented that there is no need to decide the s14(1) issue since s15(1)(c) trumps s14(1), as the provision in S15(1)(c) begins with "Notwithstanding the provisions of this Act…".

Nevertheless, on the point of whether the discounts and redemption premium were "outgoings and expenses" within the meaning of s14(1), the SGCA agreed with the SGHC that even though the discounts were in the nature of a "non-receipt" and there is no actual disbursement of money, there was a clear non-contingent legal liability or commitment to disburse the full face value of the bonds on maturity despite having received a reduced consideration upfront, and therefore such discounts were considered "outgoings or expenses".

Whether the discounts and redemption premium were "interest" under s14(1)(a)

The SGCA commented that a less liberal interpretation of the term "interest" in s14(1)(a) should be adopted, as s14(1)(a) is a specific deduction provision. Furthermore, in s10(1)(d), which deals with chargeable income, "interest" is referred to in addition to "discounts". If Parliament had intended that "discounts" and "interest" should mean the same thing, it could have defined "interest" to include "discounts". By not doing so, it should follow, as a matter of logic and good sense, that the two terms must necessarily mean different things.

On that note, the SGCA agreed[9] with the SGHC that the fundamental feature of "interest", within the context of s14(1)(a), was that it accrued with time. In other words, monetary consideration for a loan is "interest" only if the amount of consideration payable depends on the duration of the period for which the loaned money is in the borrower's hands. Based on the terms of both the 1995 and 1996 Bonds, neither early nor late redemption of the Bonds would have made a difference to the quantum of discount or redemption premium.

The discounts and redemption premium were held as one-off costs instead of "interest" and are thus not deductible under s14(1)(a).

Our comments

The conclusion that discount and redemption premium are not "interest" in the context of s14(1)(a) has limited relevance now, given the amendment in the Income Tax Act (ITA) to allow deduction for certain prescribed borrowing costs (which include discounts and redemption premiums) with effect from the YA 2008, subject to conditions.

It should also be settled in law that the analytical framework set out in T Ltd and IA is to be applied to determine the nature and deductibility of borrowing costs for Singapore income tax purposes. This includes borrowing costs such as agency fees and foreign exchange losses, e.g. if the loan is taken up to finance trading stock, such loan is revenue in nature because it is inextricably linked to a main transaction of a revenue nature, and thus such borrowing costs incurred on that loan would be treated as revenue expenditure.[11]

Of note, however, are several of SGCA's opinions which were made in obiter: -

• The specific provisions contained in s14(1)(a) to 14(1)(h) may be wider than the general deduction formula in the sense that they are not subject to restrictions contained in s14(1), e.g. for an expense to be deductible under say s14(1)(g)[12], that expense need not be wholly and exclusively incurred "in the production of the income" of the taxpayer.

• Commenting on the relationship between s14(1)(a) and s15(1)(c), the SGCA opined that interest (and prescribed borrowing costs as well with the amendment to s14(1)(a) in 2008) payable on a loan taken up for the purpose of purchasing or developing a capital asset is regarded as capital expenditure, regardless of whether the capital asset has produced income or otherwise. As such, interest (and prescribed borrowing costs) payable on a loan taken up to acquire a capital asset would ordinary fall within the ambit of the deduction prohibition in s15(1)(c), "unless and until the capital asset is employed in acquiring income" in which event the interest would be deductible under s14(1)(a), as this provision carves out an exception to s15(1)(c).

The fact that borrowing costs are tax deductible under s14(1)(a) despite being regarded as capital expenditure (e.g. if the loan relates to an accretion of capital or used to acquire or develop a capital asset) should be welcomed by taxpayers, given the importance of obtaining tax deduction on financing costs. However, it should be noted that the SGCA agreed with the position taken in T Ltd, that if a loan was used for developing a capital asset, the interest payable on that loan would not be tax deductible under s15(1)(c), but if the loan was employed in acquiring income (meaning the asset is acquired/created and is producing income) then the interest on such loan would be deductible under s14(1)(a).

• The SGCA declined to comment on whether it agreed with the contention put forth by the IRAS that since the amended s14(1)(a) was expanded to explicitly include sums "payable in lieu of interest or for the reduction thereof", the position prior to the amendment of s14(1)(a) must have been that such borrowing costs did not constitute "interest" for s14(1)(a) purposes. The Singapore Courts and ITBR are usually wary of such arguments as they offer limited assistance in determining the construction of the statutory provision in question.

Name	Contact Number	Email
Low Hwee Chua	+65 6216 3290	hwlow@deloitte.com
Daniel Ho	+65 6216 3189	danho@deloitte.com
Chua Kong Ping	+65 6530 5516	kchua@deloitte.com

[1] **14.**—(1) For the purpose of ascertaining the income of any person for any period from any source chargeable with tax under this Act
(referred to in this Part as the income), 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* —
(*a*) except as provided in this section, any sum payable by way of *interest* upon any money borrowed by that person where the Comptroller [the Respondent in the present case] is satisfied that the interest was payable on capital *employed in acquiring the income*;

[2] **15.**—(1) Notwithstanding the provisions of this Act, for the purpose of ascertaining the income of any person, no deduction shall be allowed in respect of —
...
(*c*) any capital withdrawn or any sum employed or intended to be employed as capital except as provided in section 14(1)(*h*);
...

[3] [2013] FEOL v CIT (MSTC ¶50-011)
[4] [2014] BFC v CIT (MSTC ¶70-024)
[5] The SGHC differed from the ITBR and held [at 67] that discounts and redemption premiums were actual outgoings once the bonds had been redeemed. Nevertheless, nothing turns on this issue as the discounts and redemption premiums were regarded by SGHC as capital expenditure in view that the underlying bonds were issued for a capital purpose.
[6] T Ltd v Comptroller of Income Tax [2006] 2 SLR(R) 618
[7] Comptroller of Income Tax v IA [2006] 4 SLR(R) 161

[8] At [34]
[9] At [49]
[11] At [33]
[12] Broadly, s14(1)(g) grants deduction on religious dues made under any written law