Deductibility of Expenses

This technical commentary is written *by Joanna Wong, Assistant Director, Singapore Institute of Accredited Tax Professionals (SIATP).* It is based on a SIATP's *Tax Excellence Decoded session* facilitated by *Accredited Tax Advisor (Income Tax & GST) Ong Sim Ho, Managing Lawyer of a boutique tax law practice, Ong Sim Ho*.

The decision on *BFC v Comptroller of Income Tax (CIT) [2014] by* the Court of Appeal has laid down a groundbreaking interpretation of the relationship between sections 14(1) and 15(1)(c) of the Income Tax Act (ITA). This has shed light on the murky position regarding the deductibility of certain expenses for tax purposes.

With *BFC*, there is now clarity that each sub-section of S14(1), such as S14(1)(a) or S14(1)(b), is to be considered independently of section 14(1). The deductibility of certain expenses under each sub- section is to be determined independently of the conditions stipulated by S14(1). This clarity diffuses any lingering doubts on whether S14(1) has to be considered in the course of interpreting S14(1)(a), a perspective some may have held prior to the Court of Appeal's decision.

S14(1) Deep-dived

S14(1) provides that for the purposes of ascertaining the income of a taxpayer for tax purposes, expenses wholly and exclusively incurred in the production of income is deductible. Cutting through the legal jargon, S14(1) simply provides for the deduction of revenue expenses incurred solely in the production of the taxpayer's income.

The sub-sections of S14(1) go on to extend the scope of S14(1). Meanwhile, S15(1)(c) provides that expenses of a capital nature are not deductible.

The interaction of the sub-sections, in particular S14(1)(a) with sections 14(1) and 15(1)(c), has given rise to confusion. S14(1)(a) states that interest incurred in respect of capital employed (which refers to money borrowed) in acquiring the income is deductible. To avail under section 14(1)(a), the money borrowed (capital employed) must be used to acquire income, and the income in question confined to the revenue from which the corresponding expenses are to be deducted from.

The confusion arose as a result of earlier case law which yielded the principle that interest derived its nature from the underlying loan. It followed that where the underlying loan was capital in nature, the interest incurred would be a capital expense. As a result, such interest would arguably be prohibited as a deduction under S15(1)(c). The question of the deductibility of interest thus depended on a determination of the nature of the underlying loan.

Capital or Revenue… What thou art?

To explore this issue further, an understanding of the development of various case laws is critical.

CIT v IA [2006]

The case involved a property developer who took up a syndicated loan to fund the purchase of land for the purpose of building a condominium for sale. The issue concerned in the case was whether borrowing expenses, such as prepayment penalties and guarantee expenses, incurred by the developer in connection with the repayment of a loan for developing the property were deductible. It was found that the “purpose” test, where the primary purpose of the loan (the capital employed) was taken into consideration, was relevant and should be the primary test. The “temporary and fluctuating” test, where the loan is temporary and fluctuating, is a secondary test which may be used to complement the primary “purpose” test.

An approach in resolving the issue was included in the judgement. The first step in determining if an expense is revenue or capital in nature is to ascertain the purpose of the taxpayer in entering into the loan at that point in time. Interest cannot exist without the existence of a loan, thus, the focus centres on the loan.

Next is the determination of whether there is a sufficient linkage, if any, between the loan and the main transaction for which the loan was taken. If there was no sufficient linkage, the purpose of the loan must, by its nature, mean that it merely adds to the capital structure of the taxpayer and is therefore capital in nature.

If a sufficient linkage exists, then the loan takes the cue from the main transaction. If the main transaction is of a capital nature, then the loan is correspondingly deemed to be capital in nature as well.

T Ltd v CIT [2006]

The case involved a shopping mall developer who sought to claim interest on the loans used for the acquisition of a property as a deductible expense. The judge ruled that the interest expense was inherently revenue in nature and thus deductible. However, as the expense was incurred prior to the commencement of business which in the case of property developers would be the receipt of Temporary Occupation Permit (TOP), the expense was not deductible.

At the Court of Appeal, the taxpayer appealed on the pre-commencement issue and further argued that each party should bear its own cost as this was a test case and the Comptroller had succeeded in one of two issues in contention. The taxpayer lost on both counts at the Court of Appeal. Significantly, the Court of Appeal found that S14(1)(a) itself admits only revenue expenses and thus, there was no need to resort to S15(1)(c) to prohibit the deduction of capital expenses.

BFC v CIT [2014]

The case involved the deductibility of discount on bond issues, premium paid for redemption and interest. Only interest was deemed to be tax deductible. The approach mirrored the judgements and analysis of the cases of *CIT v IA* and *T Ltd v CIT*.

The discount on bond issues and premium paid for redemption were capital in nature and thus not deductible. The Court of Appeal's view was that interest paid in respect of a capital purpose was capital expenditure and S15(1)(c) applies.

Significantly, the court also went on to hold that where a loan is taken for the purpose of purchasing or developing a capital asset, the loan is capital in nature, such that the interest payable on it is capital expenditure. The "purpose" test in *CIT v IA* was applied. Unlike the court in *T Ltd v CIT*, the Court of Appeal did not take the view that interest payable on the loan becomes revenue expenditure just because the loan is employed in acquiring income.

However, where the capital asset is employed in acquiring income, the interest payable on the loan becomes deductible under S14(1)(a). This is because S14(1)(a) did not allow the deduction of all kinds of interest, but only allowed the deduction of interest that was "payable on capital employed acquiring the income." In determining whether the "capital was employed in acquiring the income", the Court of Appeal applied the test in *T Ltd v CIT*.

It is now clear that despite being of a capital nature, interest may be deductible under S14(1)(a) as long as it is incurred on capital employed in acquiring the income. S14(1)(a) serves as an exception to S15(1)(c). This case thus effectively addresses the issue of deductibility of expenses of a derivative nature which falls under section 14(1)(a) of the ITA.

As things stand, it would appear that the test for the deductibility of interest expenses differs from the "purpose" test generally applicable for expenses deductible under S14(1).

With this case, one thing is certain. The discussion on the deductibility of income expense continues. Till the next case!

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