

GBK v The Comptroller of Income Tax [2016] SGITBR 3

In this case before the Income Tax Board of Review (Board), the Comptroller of Income Tax (CIT) disallowed tax deduction of interest expense of \$95.7m relating to Shareholder bonds issued by the Appellant. The bonds represent a restructured form of capital from equity interest held by the shareholders previously. The Board decided in favour of the CIT.



With respect to this case, we examine the key issue of whether interest expense incurred from capital restructuring would qualify for tax deduction. By capital restructuring, we are referring to the business operational strategy of making changes to the capital structure (i.e. equity and debt) of a company.

Facts of the Case

- The Appellant is in the business of owning and operating a mall.
- On or about Oct 2004, the Appellant entered into a transaction whereby it assigned its rights to the rental income from the mall to a special purpose vehicle ("SPV"), as security for a S\$520m loan.

- From Nov to Dec 2004, after the securitisation transaction, the Appellant underwent an exercise such that its capital restructure was converted from a substantially equity-based to one that is substantially debt-based by:
 - Reducing the share capital by \$330m to \$2.5m pursuant to a capital reduction exercise; and
 - Issuing fixed rate subordinated bonds of \$330m ("Shareholder Bonds") which were subscribed by the shareholders using the proceeds from the capital reduction exercise.
- The Appellant claimed deduction on the total interest expense of \$95.7m incurred on the Shareholder Bonds in the tax returns from Years of Assessment ("YA") 2005 to 2009.
- The CIT disallowed the deduction of the interest expenses incurred on the Shareholder Bonds.
- The Appellant appealed against CIT's decision and the case came before the Board in Nov 2016.

Issue before the Board

There was agreement that the amount claimed for deduction arose from the payment of interest on the Shareholder Bonds, and that the interest paid was a capital expenditure rather than revenue expenditure.

The main issue was whether the interest payments on the Shareholder Bonds has a "direct link" to the rental income such that they are deductible under Section 14(1)(a) of the Singapore Income Tax Act ("SITA") as an exception to Section 15(1) in determining the tax liability of the Appellant.



Appellant's Contention

- The capital in the form of proceeds from the Shareholder Bonds was used to *replace* the equity capital of the Appellant.
- The capital was at all times employed in and represented by its main income-earning asset i.e. the Mall from which the Appellant acquired the rental income.
- The holding of the income-earning asset would not have been possible after the capital reduction exercise if not for the alternative capital introduced.
- The circumstances in this case were akin to a case of *substituted financing* which the courts have accepted that a direct link exists. This was observed in the case *Andermatt Investments Pte Ltd v Comptroller of Income Tax [1995] 2 SLR(R) 866* ("Andermatt case") and *Yeung v Federal Commissioner of Taxation (1998) 88 ATC 4193* ("Yeung case").
- The proceeds of the Shareholder Bonds were employed to replace the shareholder's equity and provided the requisite direct link between the capital borrowed and the rental income for Section 14(1)(a) purpose, because:
 - The Appellant's capital (both the original equity and subsequent debt investment) was represented by their principal asset, i.e. the Mall; and
 - Debt financing was necessary to preserve the Appellant's ownership of the Mall from which the rental income was derived.

Therefore, the interest expense payable on the Shareholder Bonds represented interest payable on capital employed in acquiring the income and therefore should be deductible for tax purposes.

CIT's Contention

- The interest expense did not fall within the scope of Section 14(1)(a) and is prohibited by Section 15(1)(c) as:
 - The interest was not payable on capital employed in *acquiring* the rental income.
 - There is no *direct link* between the interest expense and rental income as the latter has been assigned to the SPV and the Mall had been mortgaged as security for the loan.
- There was no evidence that the proceeds from the Shareholder Bonds were used by the Appellant to acquire rental income because:
 - Rental income was already earned prior to the capital restructuring and the Shareholder Bonds were not necessary for the Appellant's holding of the Mall to derive the income; and
 - The bond issuance did not provide any additional cash flow for the Appellant.
- As the Shareholder Bonds were effectively a replacement of the equity with debt, they were not employed in acquiring the income for Section 14(1)(a) purposes.

The Board's Deliberation and Decision

On the facts of the case, the Board was of the view that:

- **There was no "direct link" between the interest expense and rental income as:**
 - The Mall was already generating rental income prior to the securitisation transaction.
 - The rental income was sufficient to operate the Mall and the securitisation and capital reduction had no impact on the generation of the said income.
 - The Shareholder Bonds had no effect on rental income as the Mall was, and continues to be in the Appellant's ownership before the issuance and redemption of the Bonds.
 - No cash flow impact as no actual monies were generated by the Shareholder Bonds.
 - The transactions from securitisation to the bond issuance should be looked at as a whole. Taken in totality, the circumstances showed that the "monies" from the Shareholder Bonds had no nexus with, and was superfluous to, the equity capital and did not substitute the loans prior to 2004 used to derive the rental income.
- **The interest expense was employed to provide the shareholders with a return of such interest, and not for earning the rental income from the Mall:**
 - It was established that the capital restructuring exercise was undertaken as a result of the abolition of the imputation system and transition to the one-tier tax system of taxing profits.
 - The shareholders intended to obtain a return in the form of interest rather than dividends as it was commercially more expedient to earn a return in the form of interest being normally paid in priority to dividends and subject to fewer restrictions. Shareholder Bonds also provide certainty as to date of repayment and flexibility of transfer if necessary.
 - The issuance of the Shareholder Bonds were not required for the preservation of the Mall.
- **There was no "substituted financing" which could otherwise have justified the tax deductibility of the interest expense:**
 - The Bonds were not a "substitute" for any type of financing as the capital restructuring was from equity to debt (rather than substituting one form of debt with another).
 - The Bonds did not replace an original loan (except for temporary debt arising from capital reduction) but were issued as the second phase of the capital restructuring.



From the above, the Board was unable to find any "direct link" for Section 14(1)(a) purposes that would constitute an exception to the prohibition under Section 15(1)(c) of the SITA.

Therefore, the CIT's decision on the disallowance of the interest expense was upheld.

Our Comments

The decision of the Board in our opinion was correct on the facts of this case. This case gives insight and provides clarity on the following issues:

- **The applicability of "direct link"**
 - It reinforces the principle from the JD case (*JD v The Comptroller of Income Tax [2005] 4 SLR (R) 705 and on appeal [2006] 1 SLR (R) 484*) that a "direct link" has to be something "real, tangible, precise and factual".
 - It also establishes the principle that something "hypothetical, speculative and not borne out of facts" would not create a direct link. The Appellant argued the remote possibility of a liquidation situation in that creditors, shareholders or liquidator would have to call upon the debt from the capital restructuring and force the sale of the Mall.
 - The Board threw out the argument and stated that "hypothetical and remote possibilities would not, at all, create a direct link".
 - On a related note, the CIT allowed deduction of the interest expense payable to the SPV under the securitisation loan as there was a direct link between the loan and rental income.
- **What constitutes "substituted financing"**
 - Substituted financing is a case where a loan refinances a prior loan and assumes the character of the previous loan. If interest on the previous loan is deductible under Section 14(1)(a), the interest on the new loan would also be deductible. Any restructuring of the capital structure from equity to debt would not constitute substituted financing.



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- **The "direct link" test precedes that of "substituted financing"**

- The Board mentioned that even if they were misdirected on the point of "substituted financing", the Appellant would still have failed the "direct link" test. This underpins the importance of establishing a "direct link" for Section 14(1)(a) purposes.

- **Commercial considerations underpinning capital restructuring exercises do not *per se* justify tax deductibility**

- While there is often much emphasis on commercial rationale and justifications behind the transactions, they do not by themselves warrant the case for tax deductibility.
- It is critical to review the tax implications of all transactions surrounding the capital restructuring exercise as evidenced in this case.

- **Foreign case law to be relied upon has to be read with caution as the statutory provisions may not be comparable with our local provisions and they may also have dealt with different factual scenarios**

- Foreign cases, while useful as references to principles and reasoning, should be analysed critically for their applicability both in terms of the law and the facts.

How we can help

As a committed tax advisor to our clients, we welcome any opportunity to discuss the relevance of the above case to your business.