KPMG

Tax alert

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Ascertaining the nature of payments

An analysis of *GFG and another v Comptroller of Income Tax*

Determining the true nature of payments in a transaction

In this tax alert issue, we analyse the recent case of *GFG and another v Comptroller of Income Tax* [2023] SGITBR 1, where the Income Tax Board of Review ("the Board") held that the true nature of the consideration received by the Appellants must be discerned not only from the mere label used in the sale and purchase agreement ("SPA"), but also from the actual substance of the transaction in question.

In this commentary, we discuss whether the Board may discern the nature of the payments under the SPA, in such a way that is not supported by the express language of the SPA itself, without invoking the general anti-avoidance provisions in section 33 of the Income Tax Act 1947.

Background

The Appellants, Dr [GFG] and Dr [GFH], practised as nephrologists and are shareholders in five companies ("Target Companies") which owned and operated 16 clinic dialysis centres (CDCs). The shares in the five Target Companies were owned in various proportions by Dr [GFG], Dr [GFH] and A Pte Ltd, a company incorporated in Singapore ("Company [A]").

Pursuant to an SPA dated 31 January 2013, the Appellants sold all their shares in the Target Companies ("Sale Shares") to Company [A] for a total consideration of S$50 million. The Purchase Consideration was payable by Company [A] to the Appellants based on the following milestones:

- S$22 million to [GFG] and S$22 million to [GFH] on the Completion Date
- S$1.5 million to [GFG] and S$1.5 million to [GFH] on the first anniversary of the Completion Date, provided they remain as Medical Directors
- S$1.5 million to [GFG] and S$1.5 million to [GFH] on the second anniversary of the Completion Date, provided they remain as Medical Directors

As seen, a sum of S$44 million was payable on the Completion Date of the share transaction and further sums of S$3 million each were payable on the first and second anniversaries of the Completion Date. Notably, with effect from the Completion Date, the Appellants were not entitled to any further payment in the form of doctor fees, management fees, and/or professional fees from the CDCs or Target Companies.

Nonetheless, the Appellants were required to serve as Medical Directors of all the CDCs and ensure the continued growth, profitability and efficient management of the CDCs for the two-year period immediately after the Completion Date ("Initial Period"). If either of the Appellants ceased for any reason to be Medical Directors of any of the CDCs during the Initial Period, the relevant milestone payments under the SPA would no longer be payable to them.

Concurrent with the execution of the SPA, the Appellants entered into Medical Director Agreements ("MDAs") with Company [A], wherein both Dr [GFG] and Dr [GFH] were appointed Medical Directors of the CDCs. The Appellants, after having served as Medical Directors of the CDCs for the Initial Period, were each paid the following sums in accordance with the SPA:

- in 2014, Dr [GFG] and Dr [GFH] were each paid S$1.5 million; and
- in 2015, Dr [GFG] and Dr [GFH] were each paid S$1.5 million.

The Comptroller of Income Tax (the "Comptroller" or the "Respondent") was of the view that the abovementioned sums, comprising four tranches of payments of S$1.5 million each, constitute taxable income of Dr [GFG] and Dr [GFH].

Accordingly, the Comptroller assessed the four tranches of payment (of S$1.5 million each) for income tax, on the basis that the pay-outs were made in consideration of the professional services provided by Dr [GFG] and Dr [GFH].

The Appellants took the opposing view that the payments were part of the Purchase Consideration for the sale of the Sale Shares and constitute non-taxable capital receipts from the disposal of the Sale Shares.

The Board, after taking into consideration the submissions made by both the Appellants and the Respondent, arrived at the conclusion that the sums totalling S$6 million were payments received by the Appellants in consideration for the provision of services, and hence constitute taxable income of the Appellants. This is despite the fact that the payments were specifically reflected as part of the consideration for the Sale Shares under the SPA.

The Appellants' perspective

From the Appellants' perspective, the nature of the consideration received should be determined with reference to the text of the SPA, and any pre-contract negotiation emails should not be admissible as evidence except in certain limited situations. In this regard, it was noted that the SPA did not contain any clause which states that Dr [GFG] and Dr [GFH] would be providing medical services in exchange for the sum totalling S$6 million.

The Appellants further pointed out that the SPA explicitly provided that the sum of S$6 million forms part of the total consideration of S$50 million for the sale of the Sale Shares. In particular, the Appellants highlighted to the Board that, for stamp duty purposes, the share transfer was stamped based on a total consideration of S$50 million, and not S$44 million (i.e. S$50 million less S$6 million).

The Respondent's perspective

While the SPA does not in any way suggest that the S$6 million was payment in exchange for medical services rendered by Dr [GFG] and Dr [GFH], the Comptroller argued that the S$6 million should be construed as payments for the Appellant's services as medical directors and nephrologists. In this regard, the Comptroller pointed to the sequence of events during the negotiation of the SPA, which showed that the transacting parties had earlier entered into a Memorandum of Understanding ("MOU") and had exchanged emails which indicated the Appellants' agreement that the sums of S$6 million were to be payment for the services rendered by the Appellants as "Medical Directors".

It was further revealed that the S$1.5 million received by each of the Appellants, for each of the two years immediately after the sale of the Target Companies, coincided with the annual medical director fees and nephrology fees that each of the Appellants had received prior to the sale of the Target Companies. In this regard, the nominal consideration of S$100, which Dr [GFG] and Dr [GFH] were to each receive for two years of services as Medical Directors of the CDCs (which include the substantive responsibility of ensuring the proper running of the CDCs), appears to be significantly inadequate under the MDAs.

The decision of the Board

In deciding in favour of the Comptroller, the Board took the view that it was not adequate to rely solely on the text of the SPA and the MDAs to discern the transacting parties' intention with regard to the sums totalling S$6 million. On that basis, the Board held that "in determining the true nature of the payments, one must look at the substance and not be bound by the label used in the SPA".

The Board hence concluded that, since the payment of the sum of S$6 million was contingent upon [GFG] and [GFH] remaining as Medical Directors of the CDCs, a proper construction of the SPA would be that the payments are conditional upon the Appellants' provision of services as Medical Directors of the CDCs. Consequently, the Appellants' argument that their services as Medical Directors were rendered for "free" was rejected by the Board.

Our key observations

Relevance of extrinsic evidence

In our view, the Board's decision appears to be significantly influenced by extrinsic evidence (beyond the text of the SPA) such as (i) the MOU entered into by the transacting parties before the actual signing of the SPA and MDAs, and (ii) the various email correspondence between the transacting parties during the negotiation stage.

The admissibility of such extrinsic evidence in construing written contracts is however governed by sections 93 and 94 of the Evidence Act 1893, which limit the extrinsic evidence which may be admitted as evidence. In this regard, it is unclear what basis the Board relied upon to disregard the general principle that extrinsic evidence should not be admissible to contradict, vary, add to or subtract from the terms of the written contract(s)[1].

It is our view that the Board has not sufficiently articulated the basis on which it is entitled to rely on extrinsic evidence in coming to its decision on the taxability of the sums. In this regard, it is relevant to remind ourselves of the principles laid down in the *Zurich* case, where the Singapore Court of Appeal held that:

> "the courts must remain ever vigilant to ensure that, in interpreting a contract, extrinsic evidence is only employed to illuminate the contractual language and not as a pretext to contradict or vary it."

In the more recent case of *MKY Capital Pte Ltd v MDR Limited* [2022] SGHC 152, the learned judge endorsed the principles laid down in the *Zurich* case and said at [49]:

> "the party seeking to rely on the extrinsic evidence in the form of pre-contractual negotiations for the purpose of interpretation must be clear in identifying the particular term, clause, phrase, sentence or expression, that the extrinsic evidence seeks to elucidate in terms of the meaning to be ascribed to it… Otherwise, the reference to the precontractual negotiations would often stray into attempts to persuade the court to re-write the contract by the introduction of terms that are not found in the written document (see *Zurich Insurance* at [122])."

Where the legal basis for the reliance on extrinsic evidence is unclear and where the Board has ignored the specific wordings of the SPA (which has unambiguously stated that the total purchase consideration for the Sale Shares is S$50 million), there is a risk that the Board is seen as re-writing the contract.

Contingent purchase consideration vs fee for provision of medical services

Notably, the Board's decision to treat the S$6 million as fees for the provision of medical services is attributable to the payment of the sums being contingent on Dr [GFG] and Dr [GFH] continuing to be the Medical Directors of the CDCs.

It is however unclear whether it is appropriate to recharacterise the contingent consideration of S$6 million as fees for the provision of medical services on that account.

In a share sale transaction, the transacting parties are at liberty to determine how the purchase consideration (including any contingent consideration) is to be structured.

There is nothing in law which prohibits the parties from agreeing to a contingent consideration for the sale of shares in a company, where the payment of the consideration for the sale of shares is contingent on the sellers continuing to manage the affairs of the company during the transition period immediately after the sale.

[1] See the Singapore Court of Appeal case of *Zurich Insurance (Singapore) Pte Ltd v B-Gold Interior Design & Construction Pte Ltd* [2008] 3 SLR(R) 1029 (the "*Zurich* case"), in particular paragraph [132], for further discussion on the admissibility of extrinsic evidence.

In our view, the Board has not sufficiently elaborated on why the S$6 million cannot be regarded as contingent consideration for the sale of the Target Companies as stated in the SPA. This is especially so, given that (i) the specific wordings of the SPA explicitly state that the "consideration for the purchase of the Sale Shares shall be S$50 million" (which includes the contingent consideration of S$6 million under dispute), and (ii) the remuneration for the provision of medical services is already separately provided for in the MDAs (albeit that the amounts payable during the Initial Period are merely nominal).

Motivation of the transacting parties

Admittedly, the fees payable to Dr [GFG] and Dr [GFH] for the provision of medical services during the Initial Period is merely nominal (i.e. S$100 each) and stands as a stark contrast to the S$1.5 million received by Dr [GFG] and Dr [GFH] each for the years immediately prior to the sale of the Target Companies. That said, it is our view that the recourse available to the Comptroller in the present case is to invoke the anti-avoidance provision under section 33 of the Income Tax Act 1947 if he is of the view that the arrangement in question is tax motivated.

However, it is noted that the Board expressly ruled out the need to invoke section 33 and stated at paragraph [33] of its decision that:

> "there is no need for the Board to further examine the alternative ground raised by the Respondents, namely the application of section 33 of the ITA for the Comptroller to disregard the payment structure in Clause 3.1 of the SPA and subject the $6 million to tax…"

In our view, there would have been a more rigorous basis for the recharacterisation of the payment of the sum of S$6 million had the Board resorted to the statutory general anti-avoidance provisions in section 33 instead. Turning our attention to the intention/motivation of Company [A], it interesting to note that the Comptroller could have faced difficulty in putting forward a coherent argument, if not for the unique facts of the present case, where (i) a representative of Company [A] wrote to the IRAS to seek clarification on whether Company [A] could claim tax deduction on (part of) the amount paid to the Appellants and (ii) the said representative testified for the Comptroller during the appeal hearing before the Board.

Based on our reading of the decision issued by the Board, the Comptroller's scrutiny of the taxability of the sum of S$6 million in the hands of the Appellants was apparently triggered as a result of Company [A]'s intention to claim tax deduction on the S$6 million paid to the Appellants. In this regard, a question inevitably arises as to whether the Comptroller (instead of bringing the S$6 million to tax in the hands of the Appellants) should have respected the express wordings of the SPA and MDAs and regarded the S$6 million paid by Company [A] as a non-deductible capital payment for the acquisition of the Sale Shares.

Substance vs form (i.e. label) vs sham

At [27] of its grounds of decision, the Board stated: “In determining the true nature of the payments, one must look at the substance and not be bound by the label used in the SPA.” In this regard, it is worth noting what Windeyer J said in *Scott v Federal Commissioner of Taxation* [No. 2] (1966) 40 ALJR 265 at 279:

> The difficult and debatable philosophic questions of the meaning and relationship of reality, substance and form are for the purposes of our law generally resolved by asking did the parties who entered into the ostensible transaction mean it to be in truth their transaction, or did they mean it to be, and in fact use it as, merely a disguise, a façade, a sham, a false front --- all these words have been metaphorically used – concealing their real transaction.

The Board however did not consider the arrangements in the SPA and MDAs, pertaining to the remuneration of the doctors, to be a sham. A sham is explained by Diplock LJ in *Snook v London and West Riding Investments Ltd* [1967] 2 QB 786 at 802 as follows:

> if [the term ‘sham’] has any meaning in law, it means acts done or documents executed by the parties to the “sham” which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual rights and obligations (if any) which the parties intend to create.

The above dictum was cited as “the classic definition of a sham” by the Court of Appeal in *Toh Eng Tiah v Jiang Angelina* and another appeal [2021] 1 SLR 1176, where Andrew Phang JCA went on to say at [80]:

> The burden of proving a sham lies on the party alleging that a document is a sham. There is also “a very strong presumption” that parties intend to be bound by the provisions of an agreement that they enter into (see *Chng Bee Kheng v Chng Eng Chye* [2013] 2 SLR 715 at [51]).

An allegation of sham is therefore a serious matter. As Neuberger J (as he then was) said in *National Westminster Bank plc v James* [2000] BPIR 1092 at [59]:

> there is a very strong presumption indeed that parties intend to be bound by the provisions of agreements into which they enter, and, even more, intend the agreements they enter into to take effect.

If the Board did not make a finding that the relevant transactions entered into between the parties were a sham, what then is the basis for making a finding of fact which is contrary to the express language of the agreements entered into between the contracting parties?

To recharacterise or not to recharacterise

In the decision issued by the Board, numerous references were made to the “substance” of the transaction between Dr [GFG], Dr [GFH] and Company [A]. While we agree that the characterisation of the true nature of a particular payment should not be bound

by the labels used in the legal documentation, one has to be careful not to unilaterally re-write the agreement of transacting parties in the name of discerning the nature of payments made under the written contract.

Under Singapore law, as in English law, where one speaks of "substance", we mean "legal substance" (*Socimer International Bank Ltd v Standard Bank London Ltd* [2008] Bus LR 1304).

In construing any written contract, one must first examine the nature of a particular payment made under the contract before deciding whether to recharacterise the nature of the payment. As an example, the mere labelling of "royalty payments" or "rental payment" as "service fees" (or vice versa) in legal agreements or financial statements should not in itself alter the actual legal substance of an arrangement. Under such a situation, it is our view that such re-labelling of the payments (e.g. relabelling a "rental payment" as "service fee" when the transaction involved the provision of services, and did not involve any rental of any movable or immovable property in the first place) is justified.

On the other hand, a recharacterisation of the nature of a particular payment could result in a "re-writing" of the written agreement of the contracting parties in the following example: A Singapore customer purchased goods from an overseas supplier with a 30-day credit terms. Although the Singapore customer was late in making payment for the purchased goods, the overseas supplier agreed in writing not to impose late payment interest on its Singapore customer for the delayed settlement of outstanding debts.

In such a situation, one should refrain from unilaterally recharacterising (part of) the purchase price paid by the Singapore customer as "late payment interest" (which may attract interest withholding tax) in the name of "substance over form". This is especially so if there is consensus *ad idem* between both transacting parties (who are unrelated) that there is no late payment interest to be imposed for the late settlement of outstanding debts.

As seen from the two examples above, each arrangement will need to be examined on a case-by-case basis to discern the true nature of the arrangement. In our view, the present appeal case is more similar to the latter example described, in that (i) there is an actual transfer of the Sale Shares for which consideration is payable and (ii) Dr [GFG], [GFH] and Company [A] have already expressly agreed in writing in the SPA that the sum of S$6 million is the consideration for the Sale Share. In this regard, recharacterising any part of the payment made under the SPA as service fee for the provision of medical services may be seen as a re-writing of the written contract.

With all due respect, it is not appropriate to construe the payments made under the SPA as consideration for the provision of services unless the anti-avoidance provision under section 33 of the Income Tax Act 1947 is invoked. While there is no doubt that the Board strives to come to a just and equitable decision, in our view the reasons for coming to the decision matters.

How we can help

As your committed tax advisor, we welcome any opportunity to discuss the relevance of the above case to your business and any transactions your business may be contemplating.

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