KPMG

Tax alert

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A case where statutory hypothesis was carried too far

Entering the world of cloud cuckoo land

Introduction

In this tax alert, we discuss the recent decision of the Valuation Review Board (VRB) in *Harmony Convention Holding Pte Ltd v Chief Assessor* [2022] SGVRB 1, (2022) MSTC 50–131 ("*Harmony*"), where the profits method was used to determine the annual value of a convention centre at which a meetings, incentives, conferences and exhibitions (MICE) business was conducted.

In Singapore, the annual value of a property for property tax purposes is its estimated gross annual rent, largely based on estimated market rentals of similar or comparable properties, and not on the actual rental income received. The hypothesis of tenancy applies even in the absence of existing tenancy for the property in question.

This statutory hypothesis stems from the definition of the term "annual value" in section 2(1) of the Property Tax Act 1960, which discusses the "gross amount at which [a property] may reasonably be expected to be let".

Where a property may be commonly let, such as an apartment, a factory or an office, and there is abundant rental evidence of similar properties, the determination of the annual value requires a common-sense evaluation of the evidence to arrive at its annual value.

Where properties are specially built for particular uses and rarely rented out (e.g. airports, public utility properties), the rental value is intrinsically linked to the returns that the owners may generate from those uses. For such specialised properties, there is no rental evidence of similar properties which may provide a guide in the determination of their annual value. In these situations, case law has endorsed the profits method (commonly known as the receipts and expenditure method in England and Hong Kong) to assess the property's annual value for property tax purposes.

In this tax alert, we discuss the recent decision of the VRB in *Harmony* involving the use of the profits method to determine the annual value of a convention centre.

The profits method

In practical terms, the profits method entails the investigation and use of revenue and expenditure numbers of the business being conducted at the property to derive the amount of rent which the hypothetical tenant is prepared to pay for the use of the property for conducting business. The methodology of the profits method was provided by Lord Atkin in *St James' and Pall Mall Electric Light Co Ltd v Westminster Assessment Committee* [1934] AC 33 at 42 as follows:

> "The system, roughly speaking, is that the gross receipts of the undertaken are taken for the year of calculation, from them are deducted the expenses of earning those receipts. From the residue, a tenant's share is subtracted a hypothetical sum which represents what the tenant might reasonably be satisfied with his "profits" which will include interest on capital, remuneration for his industry and compensation for risk, and the residue will be the landlord's share or rent."

The steps of the profits method may be expressed as a formula, as follows:

Table 1: Profits method computation

Gross receipts	$a
Less expenses of earning those receipts	$b
Divisible balance (DB)	$a - $b
Less: Tenant's share (TS)	C% x ($a - $b)
Annual value (i.e. landlord's share or rent)	DB - TS

Statutory hypothesis – cloud cuckoo land?

The formula looks simple enough, until the Chief Assessor of the Inland Revenue Authority of Singapore (hereafter, the "Respondent") tried to deny the deduction of some expenses from gross receipt earnings (i.e. pertaining to $b) which would in turn result in an increase of the annual value of the property. In this case, the Appellant outsourced its day-to-day operations to a convention and exhibition services (CES) operator (hereafter "CES Service Provider").

The main issue in dispute revolves around the deductibility of the CES operator's fee as an operating expense under the profits method. The Respondent perceived the CES Service Provider as a hypothetical tenant and denied the deduction of operator fees paid by the Appellant to the CES Service Provider, on the argument that a hypothetical tenant would not outsource its own operations. The issue arose as to whether such an argument may be made, on the back of the statutory hypothesis.

To those unfamiliar with the statutory hypothesis in property tax (or rates/rating as it is called in Hong Kong and England), the concept requires one to enter into a world of "make believe" or "cloud cuckoo land". As Godfrey JA said in the Hong Kong Court of Appeal case of *China Light and Power Co Ltd v Commissioner of Rating and Valuation* [1995] 2 HKC 42 (a rating case concerning the use of the profits method in assessing the annual value of power stations):

> "The world of rating appears, to one unfamiliar with the arcana, to be cloud cuckoo land, a world of virtual unreality from which real cuckoos are excluded (although it seems that permission to land will be granted to a cuckoo flying in from the real world if it can demonstrate that its presence in cloud cuckoo land is essential, not merely accidental: see *Dawkins (Valuation Officer) v Ash Brothers & Heaton Ltd*)."

But the licence of the statutory hypothesis, or statutory "make believe", must not be carried too far in a valuation exercise, as the VRB would remind us in the case of Harmony. For those familiar with the principles concerning the construction of deeming provisions, the phrase, "the hypothetical must not be allowed to oust the real further than obedience to the statute compels" (per *Megarry VC in Polydor Ltd and RSO Records Inc v Harlequin Record Shops Ltd and Simons Records Ltd* [1980] 1 CMLR 669 at 673) would ring a similar affirmative tone. Indeed, Godfrey JA's reference to "cloud cuckoo land" in *China Light and Power* would receive the following rejoinder by Bokhary PJ in the Hong Kong Court of Final Appeal case of *Hong Kong Electric Co Ltd v Commissioner of Rating and Valuation* [2011] CPR 298 at [5]:

> "Throughout my life in the law, I have always regarded reality as a touchstone. If there truly is a separate rating world, then I am a mere visitor to it. And as such, I was initially somewhat bemused by statements made in some of the cases to the effect that rating operates in a world of unreality or worse. As it seems to me upon closer inspection, however, there is no unreality in rating beyond that which is forced upon it by the requirement that the rateable value of a tenement be ascertained in terms of the hypothetical year-to-year tenancy laid down in s 7(2) of the Rating Ordinance."

A case of statutory "make believe" carried too far

In this case, the Chief Assessor (i.e. the Respondent in the appeals) had previously allowed the deduction of CES fees (acknowledged by the Respondent as being at arm's length in these appeals) incurred by the Appellant in the operation of the MICE business at the property, in arriving at the annual value of the property. Sometime in 2016 the Respondent decided to disallow the deduction, which resulted in a higher annual value for the property.

The Respondent's formulation of the construct for the non-deduction of the CES fees before the VRB purportedly rested on the statutory hypothesis. While acknowledging that the CES fees are at arm's length, the Respondent nevertheless contended that the hypothetical tenant would not incur the CES fees on the assumption that a hypothetical tenant would not outsource its day-to-day operations. Such an assertion attracted the rejection of the VRB, which cited a 19th-century Singapore rating case concerning the use of the profits method in the assessment of the annual value of the wharf and dock properties of the Tanjong Pagar Dock Company[1]. The VRB stated at paragraph 42 of its Grounds of Decision (GD):

"The hypothetical tenant may also adopt the business model used by the actual business owner of the property being assessed. As stated by Sidgreaves CJ in the case of *Tanjong Pagar Dock Co v Municipal Commissioners* (1885) 4 Ky 103 (at page 107):

"… The question is what view would an incoming tenant take of these various items of expenditure and how would they affect the rent which he might be reasonably expected to pay for the occupation of the property, assuming that he would carry on the same business under the like circumstances. **It is not unreasonable to suppose that, looking at the success which has hitherto attended the operations of the Company and the position it has now attained, the supposed tenant would wish to carry on the business as far as possible in a precisely similar manner to that in which it is now carried on. He would assume that the object of the Company had been to make the business as remunerative as possible** and to do that they would naturally have endeavoured to bring down the working expenses to as low a point as was compatible with efficiency."

[emphasis added by the VRB]

The Respondent's construct for the non-deduction of the CES fees involved the interweaving of the following elements as articulated by the Respondent's witness, one Ms Lee:

1) First, there is to be the cloaking or substitution of the CES Service Provider (who is a service provider to the Appellant) as a "hypothetical tenant" in place of the Appellant (which is the owner of the property, as well as the operator of the MICE business carried on at the property, and which is typically a hypothetical tenant according to case law *The Railway Assessment Authority v The Southern Railway Company* [1936] AC 266, *The London County Council v The Churchwardens and Overseers of Erith and West Ham* [1893] AC 562). The VRB rejected the assumption and stated the following at paragraph 48 of its GD:

"Furthermore, there appears to be an inconsistency within Ms Lee's submission [for the Respondent] that the CES Operator's [Service Provider] role, responsibilities and objectives are the same as a hypothetical MICE business operator's roles and responsibilities. The CES Operator [Service Provider] does not commit to a rent in this instance."

2) Having adorned the CES Service Provider as a "hypothetical tenant", the Respondent then made the leap that a hypothetical tenant would operate a MICE business itself without outsourcing its tasks, and therefore would not pay the CES fees. With such a flourish, the Respondent attempted to wish away the deduction of the CES fees, but this was rejected by the VRB which stated at paragraph 47 of its GD:

"In our view, Ms Lee had erred in her fundamental assumption that the hypothetical tenant in this case can only be an independent MICE business operator who will rent the Property and will undertake all the MICE operations itself without outsourcing. That is clearly not the current situation or business model adopted on the Property. The Respondent's case and submission on the deductibility of the CES Fee rests solely on this assumption -- that the hypothetical tenant is a MICE business operator who is capable of and undertakes the entire MICE operations itself and as such would never incur the CES Fee as a necessary expense such that it can be deducted as a working expense."

[1] The Tanjong Pagar Dock Company was nationalised by the colonial government in the early part of the 20th century and was renamed the Tanjong Pagar Dock Board, which in turn was later renamed the Singapore Harbour and subsequently the Port of Singapore Authority.

3) Also underlying the cloaking of the CES Service Provider as a hypothetical tenant is the motive of characterising the payment of the CES fees to the CES Service Provider as a reward to the hypothetical tenant of the subject property, which is to be accounted for in the tenant's share (see: Table 1) such that the CES fees are not deducted as an expense of the MICE business. The artifice was however rejected by the VRB, which stated the following at paragraph 47 of its GD:

> "The CES Fee is regarded and treated by Ms Lee as a reward earned by the hypothetical MICE business operator and with that characterisation, the CES Fee is more appropriately accounted for under the tenant's share. We agree with the Appellant's submission at page 29, paragraph 59 of the Appellant's Closing Submissions that "The Respondent must not be allowed to create hypothetical competitors or hypothetical (and untrue) circumstances to fix the rent, under the Profits Method."

4) To prop up the cloaking, the Respondent used the Appellant's audited financial statements and asserted that the revenue generated and expenditure incurred (through the outsourced work of the CES Service Provider) were "channelled" to the Appellant — a concept repugnant to fundamental accounting principles and commercial reality. The Appellant's audited financial statements clearly reflect the Appellant's own revenue and expenditure numbers, while the CES Operator's own revenue (i.e. the CES Fee earned) and expenditure numbers are reflected in its own financial statements. At the same time, the Respondent seemed oblivious to the apparent contradiction that this use of revenue and expenditure numbers, as provided by the Appellant's financial statements, supports the proposition of the Appellant as a hypothetical tenant, and betrays the cloaking.

5) As regards the conflation of the deduction of the CES fees with the deduction of the tenant's share, in the Respondent's argument that the tenant's share already reflected the CES fees, the VRB rejected the proposition of the Respondent and stated at paragraph 52 of its GD:

> "We accept the submission that the CES Fee represents a fee paid to a service provider, agreed between parties, negotiated at arm's length, and approved by the companies who are substantial owners of the Appellant. As a fee paid to a service provider, the CES Fee cannot be accounted for under the tenant's share as Ms Lee had advocated. It is, in this instance, a fee incurred by the Appellant to earn the receipts of their MICE business conducted at the Property and should be deducted as an expense."

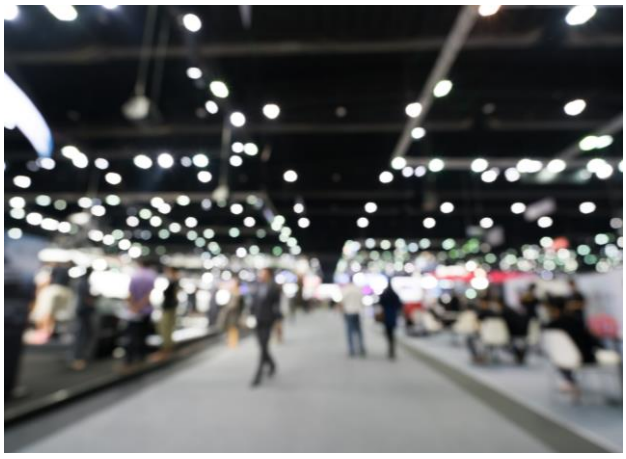
In the final analysis, the VRB concluded that "the Appellant has thus proven the Respondent's proposed annual values are excessive as the CES fees had not been appropriately deducted" in paragraph 52 of the GD. The VRB also made the following damning finding at paragraph 47 of its GD:

> "We agree with the Appellant's submission at page 29, paragraph 59 of the Appellant's Closing Submissions that "The Respondent must not be allowed to create hypothetical competitors or hypothetical (and untrue) circumstances to fix the rent, under the Profits Method."

How we can help

Leung Yew Kwong and See Wei Hwa of KPMG Services Pte. Ltd. argued successfully for the taxpayer in *Harmony Convention Holdings Pte Ltd v Chief Assessor* at the Valuation Review Board. The Chief Assessor did not appeal further.

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



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