

In this issue of Tax Alert, KPMG Tax Services examines the court decision on three recent case laws concerning the deduction of certain expenses for income tax purposes.

## Update on Recent Case Laws

Under the Singapore income tax system, the claim for deduction of expenses is governed by section 14 of the Income Tax Act (ITA) which provides the general deduction rules and makes specific reference to certain categories of expenses that are deductible for income tax purposes. However, it is by no means an exhaustive list. Although expenses that are statutorily not deductible for tax purposes are set out in section 15 of the ITA, it is also not comprehensive. Hence, disputes with the Comptroller of Income Tax (CIT) on the deductibility of expenses are not uncommon and recently, a number of such cases were heard before the courts of Singapore.

In this Alert, we examine the decisions of the Court of Appeal, the High Court and the Income Tax Board of Review (ITBR) on three recent case laws which we outline and discuss below.

### *JD Ltd v Comptroller of Income Tax [2005] SGCA 52*

On 2 December 2005, the Court of Appeal dismissed the appeal by the taxpayer and affirmed the decision of the High Court that interest expense incurred in relation to non-income producing share investments are not deductible for income tax purposes.

## About Tax Alert

KPMG's Tax Alert highlights the latest tax developments, impending change to laws or regulations, current practices and potential problem areas that may impact your company. As certain issues discussed herein are time sensitive it is advisable to make plans accordingly.

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### *Background*

The taxpayer, a listed investment holding company, financed the purchase of its share investments using a mixed pool of funds obtained mainly from:

- overdrafts and loans from banks and related companies at varying interest rates;
- issuing its own shares; and
- interest-free loans from related companies.

In the years of assessment in dispute, the taxpayer did not receive dividends from some of the companies in which the taxpayer invested. The CIT assessed the taxpayer on the basis that only interest expenses attributable to shareholdings that produced income were deductible. Interest expenses attributable to non income-producing shareholdings were not deductible. This is based on the CIT's tenet that each share investment counter constitutes a separate source of income. Accordingly, deductions of interest expenses were allowed only for those shareholdings which yielded dividend income in the basis period of each relevant year of assessment

### *Findings*

The Court of Appeal agreed with the High Court's decision and dismissed the appeal based on the following findings:

- The source of dividend income must necessarily stem or originate from the particular share counter that yielded the revenue;
- Shareholdings in different companies constitute different sources of income and the shares of one company may generally be treated as a single shareholding;
- There must be a matching of expenses against each individual source of dividend income; i.e. expenses are not deductible on an aggregated basis against the total of all sources of income;
- Only interest expenses attributable to the income-producing share investment counters are deductible;
- Expenses are deductible only when income is produced;
- Interest expense is deductible where the CIT is satisfied that it is payable on capital employed in acquiring the dividend income.

### **Comments**

The decision of the Court of Appeal may adversely impact taxpayers who are attempting to claim interest expense deductions on the premise that all dividend income constitutes a single income source. Taxpayers who are involved in share investments or intend to purchase share investments would need to review their financing structure or plan for such investments in order to mitigate any potential disallowance of interest expenses

### ***IA v Comptroller of Income Tax [2005] SGHC 229***

On 22 December 2005, the High Court ruled in favour of the taxpayer and found the borrowing expenses, prepayment penalty and guarantee expenses to be deductible under section 14 of the ITA.

### *Background*

The taxpayer carries on the business of a property developer and obtained a syndicated loan to finance the purchase of a parcel of land for the development of

a condominium project and incurred borrowing expenses. Subsequently, when the taxpayer received revenue receipts from progress payments made by purchasers of the apartments in the condominium project, it decided to repay the syndicated loan. In this regard, the taxpayer was required to obtain bank guarantees for the amount of withdrawal from the project account with respect to the revenue receipts under the Housing Developers Rules. The taxpayer incurred guarantee expenses and the repayment of the syndicated loan also resulted in a prepayment penalty.

The taxpayer claimed deduction for the borrowing expenses, prepayment penalty and guarantee expenses but the CIT disallowed them on the grounds that they are capital expenditure. The taxpayer appealed to the ITBR and its appeal was dismissed. The taxpayer then appealed to the High Court.

#### *Findings*

The High Court allowed the appeal in respect of borrowing expenses, prepayment penalty and guarantee expenses as deductible expenses within section 14(1) of the ITA based on the following findings:

- As the syndicated loan was obtained solely to purchase the land and finance the development costs that formed its trading stock, the loan is revenue in nature. The borrowing expenses arising from the loan were accordingly also held as being revenue in nature;
- The prepayment penalty was incurred to avoid paying further interest arising from the syndicated loan (i.e. to commute or extinguish a contractual obligation to make recurring revenue payments) and hence it is revenue in nature;
- The guarantee expenses were not incurred to enlarge the capital of the taxpayer but to facilitate the release of the funds in the project account to pay off the syndicated loan which was for the purpose of acquiring trading stock.

#### **Comments**

In arriving at its decision, the High Court preferred to focus on the purpose for which the loan was obtained and used as opposed to the nature of the loan itself; i.e. whether the loan was of a temporary and fluctuating nature, in determining the revenue or capital nature of the borrowing and other associated costs. The decision of the High Court provides much needed guidance to taxpayers in the light of the perennial revenue versus capital controversy. It is not presently known if the CIT is appealing against the decision.

#### ***KD v Comptroller of Income Tax [2005] SGITBR 3***

On 1 August 2005, the ITBR upheld the appeal of a taxpayer that both the settlement sum and the legal expenses incurred with respect to claims of infringement on a patent are deductible for income tax purposes.

#### *Background*

The taxpayer, a Singapore company, was engaged in legal proceedings over the manufacture and sale of certain products for which a patent had been validly registered in France by a non-profit private foundation, and granted exclusively to another French company. In September 2001, the taxpayer settled the



infringement claims by paying a settlement sum to compensate the above two parties for the losses they suffered during the infringement period. The taxpayer also incurred legal expenses.

The issues are whether the settlement sum and/or legal expenses are deductible for Singapore income tax purposes.

#### *Findings*

The ITBR took into consideration section 14(1) and 15 of the ITA and decided that both the settlement sum and the legal expenses were deductible for income tax purposes based on the following findings:

- The settlement sum and legal expenses were revenue in nature as no assets or any enduring advantage was acquired by the taxpayer. The taxpayer was not seeking to defend its capital asset or eliminate competition as the patent did not belong to it.
- The expenses in question were incurred for the purposes of the taxpayer's business activities which were carried out with the objective of producing income.

#### **Comments**

In arriving at the decision for the case, the ITBR commented that the settlement sum and legal expenses were incurred to deal with the liability arising out of the taxpayer's business activities which were carried out with the objective of producing income; hence, the expenses were deductible for income tax purposes. The ITBR's decision favours a broader approach in the interpretation of the phrase "in the production of income" and provides useful guidance for claims in respect of similar business expenses. However, it is not known if the CIT is appealing against the decision.

#### **KPMG Tax Services can help**

If you have any enquiries on the cases discussed above or need assistance in reviewing the deductibility of similar expenses, your KPMG Tax Services adviser can assist.

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