

BML v Comptroller of Income Tax [2017] SGHC 118

In this case, the High Court upheld the decision of the Income Tax Board of Review (Board) that for interest deductibility under Section 14(1)(a), there is a need to establish a direct link between the money borrowed and the income produced.

In [Issue 20 \(March 2017\)](#) of our Tax Alert, we examined this case before the Board. Subsequent to the decision of the Board in favour of the Comptroller, the Appellant (renamed from GBK to BML for the case report) appealed to the High Court.

The key issue of this case relates to the deductibility of interest expenses incurred by the taxpayer on certain fixed rate subordinated bonds further to a capital restructuring exercise.



Facts of the Case

- The Appellant is in the business of owning and operating a mall.
- In 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, as security for a loan.
- After the securitisation transaction, the Appellant underwent an exercise such that its capital structure was converted from a substantially equity-based to one that is substantially debt-based by:
 - Reducing the share capital by a capital reduction exercise; and
 - Issuing fixed rate subordinated bonds (Shareholder Bonds) which were subscribed by the shareholders using the proceeds from the capital reduction exercise
- The Appellant claimed deduction on the interest expense incurred on the Shareholder Bonds in the tax returns from Years of Assessment (“YA”) 2005 to 2009.
- The Comptroller disallowed the deduction of the interest expenses incurred on the Shareholder Bonds.
- The Appellant appealed against Comptroller’s decision and the case came before the Board.
- The Board was unable to find any “direct link” for s 14(1)(a) purposes that would constitute an exception to the prohibition under s 15(1)(c) of the Act and the Comptroller’s decision on the disallowance of the interest expense was upheld.
- The Appellant appealed to the High Court.



Decision of the Board

A summary of the Board's decision is as follows:

- There was no "direct link" between the interest expense and rental income.
- The interest expense was employed to provide the shareholders with a return of interest income, and not for earning the rental income from the Mall.
- There was no "substituted financing" which could otherwise have justified the tax deductibility of the interest expense.

The Basis of Appeal by Appellant

- The Appellant appealed to the High Court on the basis that the Comptroller and the Board had interpreted s 14(1)(a) of the Act wrongly. Specifically, they argued that:
- The question is whether the interest paid on the shareholder bonds is according to s 14(1)(a). If so, the interest should be deductible against that particular income for tax purposes as this is all that the statute requires. In *BFC v Comptroller of Income Tax*, it was held that for interest expenses to be deductible under s 14(1)(a), the general deductibility test under s 14(1) does not need to be fulfilled. It is also an exception to the non-deductibility in s 15(1)(c). This means that although interest expenses payable on capital employed in acquiring the income are considered capital expenditure, they are deductible under s 14(1)(a).
- The Comptroller is not empowered by s 14(1)(a) to look behind the transaction into the subjective purpose or necessity of the money borrowed when he determines whether the interest is indeed payable on capital employed in acquiring the income.

Decision by the High Court

The Judge dismissed the appeal based on the following:

- The governing test under s 14(1)(a) is that there should be a direct link between the money borrowed and the income produced and that the Comptroller is given the discretion under s 14(1)(a) to determine whether its requirements have been satisfied.
- In this case, there are problems in establishing a direct link between the shareholder bonds and the Mall's rental income.
- The Comptroller's determination and Board's decision is not unreasonable or wrong. The Court will not intervene unless it is proven that the Comptroller has taken irrelevant considerations that was material to its findings or arriving at an objectively unreasonable result.

Our Observations and Comments

The decision of the High Court was correct on the facts of this case. This case gives further insight and provides clarity on the following issues:

1. **The key test under s 14(1)(a) is the need for direct link between money borrowed and income produced.**
 - a) The need for a direct link was affirmed in the leading case on s 14(1)(a) interpretation, *Andermatt Investments Pte Ltd v Comptroller of Income Tax [1995]* and followed in other cases such as *JD v Comptroller of Income Tax [2006]*. The statutory language "sum payable by way of interest ... payable on capital employed in acquiring the income" in s 14(1)(a) requires such a link.

2. The direct link to be established requires more than a look at the company's balance sheet.
 - a) This provision cannot be read as simply requiring a company's capital be represented by income-producing assets. This would invite companies with such assets to seek deductions merely by making changes to their capital structure by creating debt in the balance sheet regardless of whether the loan taken was needed for, instrumental to, or had any direct link to the income produced.
3. The direct link has to be real, tangible, precise and factual, and requires the consideration of a number of factors.
4. Section 14(1)(a) gives the Comptroller discretion in deciding whether or not a direct link exists, and how much deduction should be allowed.
5. "Substituted financing" (i.e. replacing sources of financing) does not in itself entitle a taxpayer to deduction.
 - a) The ultimate question will still be whether there can be a direct link between the substituted finance and the income produced.
 - b) There may be instances where it can reasonably be said that there is a direct link when loan capital replaced equity capital, such as where a new loan replaces a previous loan (as seen in Australia's *Yeung* case), but it cannot be applied to the Appellant's case.
6. Whether a direct link exists between the money borrowed and the income produced is not determined solely on the taxpayer's intention.
 - a) Intention does not in itself prove a direct link where none exists, and it also cannot sever the link once the link has been established. However, intention is relevant in some cases to show how the capital has been established, especially when the statute itself implies a purpose such as the acquisition of income.
7. The necessity to issue the shareholder bonds further to the capital reduction exercise, in order to preserve its assets, does not provide the direct link stipulated above.

How We Can Help

As your committed tax advisor, we welcome any opportunity to discuss the relevance of the above case to your business. Please feel free to contact us if you require any assistance.

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