IN THE COURT OF APPEAL OF THE REPUBLIC OF SINGAPORE

[1995] SGCA 63

CA 163/1994

Between

Andermatt Investments Pte Ltd

… *Appellant*

And

Comptroller of Income Tax

… *Respondent*

GROUNDS OF DECISION

Revenue Law — Income taxation — Deduction

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Andermatt Investments Pte Ltd v Comptroller of Income Tax

[1995] SGCA 63

CA 163/1994
Chao Hick Tin J; Karthigesu JA; L P Thean JA
12 August 1995

1 Cur Adv Vult

2 This is an appeal against a judgment of the High Court which dismissed the appellant`s appeal against a decision of the Income Tax Board of Review (the Board) which affirmed an assessment of the Comptroller of Income Tax. [See [1995] 1 SLR 66 .] The question in issue concerns essentially the deductibility of an amount of $201,172 under s 14(1)(a) of the Income Tax Act (Cap 134) (the Act), paid as interest by the taxpayer, the appellant, to a bank.

3 The facts of the case, which have been agreed to by the parties, are as follows:

> (1) Andermatt Investments Pte Ltd (the appellant company) was incorporated on 28 November 1987 for the purpose of carrying on the business of investment holding including, inter alia, owning and leasing out the property known as No 1 Jalan Remaja, Singapore 1027 (the Hillview Property).
>
> (2) The Hillview Property was originally held by Wan Holdings Pte Ltd (Wan Holdings), a company carrying on the business of investment holding. The Hillview Property was acquired and constructed by Wan Holdings at a cost of $3,446,630. Wan Holdings obtained a bank overdraft to finance the construction

of the Hillview Property. The construction of the Hillview Property was completed in 1977 and revalued in 1987 to $8,500.000. The bank overdraft which was used to finance the construction of Hillview Property was repaid by Wan Holdings in March 1981. At all material times the property was earning rental income.

(3) On 8 December 1987 the appellant company purchased all the issued shares of Wan Holdings from the shareholders of Wan Holdings at a consideration of $20,000,030, and the appellant company became the holding company of Wan Holdings.

(4) Both the appellant company and Wan Holdings are (or were as the case may be) owned by the same members of the Wan family.

(5) $1,000,000 of the purchase consideration was paid by the appellant company from its paid-up share capital of $1,000,000. The remaining purchase consideration of $19,000,030 stood as a debt owing by the appellant company to the vendors.

(6) On 31 December 1987 the sole shareholder of Wan Holdings passed the requisite resolutions to initiate the winding-up of Wan Holdings by way of a members` voluntary winding-up, and to appoint liquidators forthwith.

(7) On 8 February 1988 the appellant company obtained an overdraft facility of $6m from Overseas-Chinese Banking Corp Ltd (OCBC). $5,800,000 of this facility was drawndown by the appellant company to satisfy part of the remaining purchase consideration as follows:

(i) $2,800,000 on 23 May 1988;

(ii) $1,000,000 on 31 May 1988; and

(iii) $2,000,000 on 30 June 1988.

(8) The Hillview Property was distributed by the liquidators of Wan Holdings to the appellant company on 31 March 1988 as a return of capital in specie.

(9) In the financial period from 28 November 1987 to 31 December 1988, the appellant company derived dividend income of $4,620,007 from its holding of the Wan Holdings shares. This was received by the appellant company on 5 January 1988. In the same financial period the appellant company also derived rental income from the Hillview Property in the amount of $599,845.54. Other than the rental and dividend income stated above, the appellant company did not derive any other income during the said financial period.

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> (10) In the same financial period the appellant company incurred interest costs on the $5,800,000 drawdown on the OCBC facility of $201,172.00.
>
> (11) The appellant company, through its tax agents, Boon Suan Lee & Co, submitted a tax computation of the appellant company`s income tax liability for the year of assessment 1989 in which the interests costs of $201,172.00 was claimed as a deduction against its trading income, from the business of investment holding.
>
> (12) By notice of additional assessment No 20-0078762-5 dated 16 August 1991 the Comptroller of Income Tax assessed the appellant company for the year of assessment 1989 to additional tax in the sum of $62,173.35 on the basis of the interest deduction of $201,172.00 being not allowable.

4 As the case concerns the construction of s 14(1), in particular sub-para (a), we will now set out that provision:

> *For the purpose of ascertaining the income of any person for any period from any source chargeable with tax under this Act (referred to in this Part as the income), there shall be deducted all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of the income, including -*
>
> *(a) except as hereinafter provided, any sum payable by way of interest upon any money borrowed by that person where the Comptroller is satisfied that the interest was payable on capital employed in acquiring the income.*

5 The Board in affirming the Comptroller`s refusal to allow the deduction held that in order for the interest to qualify for deduction under s 14(1)(a) two conditions must be fulfilled:

> (i) there must be a `direct link` or `close connection` between the money borrowed and the income produced; and
>
> (ii) the link between the original purpose of the loan and the income must not be severed.

6 **Appellant`s contention**

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7 The main contention of counsel for the taxpayer appellant is that the facts clearly show that the overdraft was taken to enable the appellant to complete the acquisition of the Hillview property. It was always the intention of the appellant to acquire the Hillview property. The acquisition of the shares in Wan Holdings was merely an interim step designed to take advantage of the concession given in the Stamp Duties Act (Cap 312) by which a transfer of shares in a company attracts duty at 0.2% while duty on the transfer of the underlying property in the company is at a rate of about 3%. Thus, the interest incurred on the overdraft should be deductible against the rental income derived from the property.

8 Counsel submitted that although the acquisition of the Hillview property took two steps to complete (first the purchase of shares and then the property), the connection between the money borrowed from OCBC and the rental income of the property was plainly there: they were linked. Without the overdraft the appellant could not have acquired the Hillview property which earned the rental income. The property was even mortgaged to secure the overdraft.

9 He contended that s 14(1)(a) talks of `capital employed in acquiring the ***income*** ` and not `the assets`; thus the assets acquired could alter so long as it could be shown that the income in question is linked to the loan obtained; it did not have to follow that the loan must be used to acquire the original asset. The law does not require that the historical link between the loan and the asset must always be preserved for interests to be deductible. Section 14(1)(a) is concerned with how capital was employed during the period in which the interest was incurred, not how the capital was employed when first raised or during some other period. It did not matter that the overdraft funds were used to pay the vendors of the shares of Wan Holdings. The pertinent question is not to whom the overdraft money was paid but for what: it was paid to enable an income-

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producing asset to be acquired. Thus, as long as the necessary linkage can be shown between the income being earned and the maintaining of the overdraft, the interest is deductible.

10 Counsel submitted that the learned judge below erred in the following respects:

> (i) In holding that as the Hillview property had already been distributed to the appellant when the overdraft was drawn up, the interest was not incidental or relevant to acquiring the rental income;
>
> (ii) in finding that the money borrowed did not replace original funds employed in acquiring income in respect of profits from trade;
>
> (iii) in holding that if an asset (acquired with borrowed money) is substituted in the normal course of business from one producing dividends to another producing say rent the deductibility of the interest on the loan shall come to an end.

11 **Respondent`s submission**

12 The respondent`s submission is that the overdraft was drawn to extinguish an existing debt. It had nothing to do with the acquisition of the Hillview property. The overdraft was arranged in February 1988. Drawdowns were only made in May and June 1988. At that point in time the Hillview property had already been transferred to the appellant who was entitled to the rent arising therefrom. The overdraft was used by the appellant to pay the debt due to the vendors of the Wan Holding shares. Thus, the interest incurred is not deductible because it was not interest on `capital employed in acquiring the (rental) income` - the capital was employed to pay up a debt due to the vendors of the shares: see ***Thwaites v Commissioner of Income Tax*** . The vesting of the property as a return of capital in specie cannot convert an overdraft taken to

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extinguish a liability to be an overdraft to finance the purchase of the property. The interest expense paid to OCBC cannot be linked to the rental income, which is a distinct and separate source of income from dividends. The interest only became payable when the overdraft was drawn by which time the property had already been transferred to the appellant. The debt due to the vendors of the shares is a different matter altogether.

13 As regards the alternative argument of substitution, that the property was substituted for the shares, the respondent submitted that the rent received, which is a profit from trade under s 10(1)(a) of the Act is completely different from income from dividends - the substitution resulted in the original source of income coming to an end and the commencement of a new source of income and that the interest payable for acquiring shares cannot be deducted from profits from trade. Furthermore, the money borrowed did not replace original funds employed to earn profits from trade. Here, the trade commenced only when the Hillview property was transferred to the taxpayer.

14 The respondent relied upon the Malaysian case ***Ampat Tin Dredging Ltd v Deputy General of Inland Revenue*** where the point in issue was whether payment of retrenchment benefits because of closure were `outgoings and expenses ***wholly and exclusively incurred*** during that period ... ***in the production of gross income*** from that source.` The High Court there held that the expenditure must be only for the `direct purpose` of producing the income. It held that the payments were not made in order to produce income because the taxpayer was going out of business. We would agree that the Malaysian wording is somewhat clearer than our wording.

15 **Australian cases**

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16 The appellant has relied upon a number of Australian cases to support its contention. Two of the Australian cases cited by the appellant are ***Begg v Federal Commissioner of Taxation*** and ***Federal Commissioner of Taxation v Total Holdings*** . In ***Begg*** the executors withheld realization of income-producing property during the depression and borrowed from a bank to pay estate duty and estate debts. The executors sought to deduct the interest paid to the bank from the income. Interpreting s 23 of the Australian Income Tax Assessment Act 1922-34 (the earlier equivalent to the present s 51), Reed AJ held that a real and substantial relation between the payment of interest and the production of the income had been established. He stated that `it can be said that if the loans had not been arranged, and the interest had not been paid, the assessable income would not have been nearly as much as it is.` Towards the end he added (at p 270): `I do not understand the authorities to lay it down that in order that the money expended shall be allowable as a deduction it must directly cause the production of income, in the sense that the income or some portion of it can be pointed to as being the direct result of the expenditure.`

17 In ***FCT v Total Holdings (Australia) Pty Ltd*** where interest arising from a loan taken from a parent company by the taxpayer company and on-lent interest-free to its operating company was held to be deductible as such a course of action was designed to render its operating company profitable as soon as commercially feasible and to promote the generation of income by the operating company and its subsequent derivation by the taxpayer company and thence the parent company. The court held that the liability for interest of the taxpayer company to the parent company was incidental and relevant to the derivation of the taxpayer`s income and was part of its business activities and thus satisfied the tests in s 51(1). In his judgment, Lockhart J (at p 4283) stated:

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> *If a taxpayer with a continuing business incurs a liability for interest being incidental to or connected with the operations or activities regularly carried on for the production of income, the interest is an allowable deduction. The circumstances that each item of expenditure cannot be traced to a particular item of income does not prevent the deduction of the expenditure.*

18 In contrast there is the case ***Federal Commissioner of Taxation v Munro*** where the taxpayer was already the owner of land on which buildings stood and which were leased to tenants. He obtained a bank loan for the purpose of purchasing shares in a newly incorporated company and for making advances to the company. The land he owned was mortgaged as security to the bank for the loan. The taxpayer claimed to be entitled to deduct the interest payment to the bank from the rental income. The Australian High Court held that the taxpayer`s assessable income was in no way referrable to the transaction with the bank out of which the liability to pay interest arose. The loan by the bank was in no way instrumental or conducive to the production of the assessable income. Before the mortgage was given, the taxpayer was already entitled to the rents on the property from his tenants and he did not gain them nor were they produced in consequence of the payment of interest.

19 The facts of none of these cases are near to the present case. Moreover the wording of relevant Australian provisions (s 51) are not in pari materia with the Singapore provision. There are, inter alia, these two areas of differences. First, in Australia, a taxpayer`s gross income has to be ascertained before deductions are allowed whereas in Singapore deductions are allowed on each and separate source of income of the taxpayer. In other words there has to be a matching of expenses against each individual source under the Singapore law. In Australia this is not required. Expenses which generate income can be deducted against the cumulative income of the taxpayer. Second, under the Australian Act in view of the words `to the extent to which they are incurred` it

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is clear that the losses and outgoings are apportionable, which does not appear to be possible under our law. Therefore, we think the Australian cases should always be considered bearing the differences in mind.

20 **Construction of s 14(1)(a)**

21 Section 10(1) sets out the various sources of income which are subject to tax. The appellant accepts that `the income` in s 14(1)(a) refers in the present case to the rental income and not to income generally. Interest incurred on capital is to be deducted from that source of income to which the capital has been employed and not from any other source of income. Where the interest incurred exceeds the income from that source the excess is not available as a deduction from income from another source.

22 There is apparently no authority on point to the instant case. However, the respondent relied upon the Jamaican case ***Thwaites*** which the court below accepted as being pertinent. There, the taxpayer purchased shares in a company on credit and agreed to pay interest annually on any unpaid purchase money in respect of the shares. He did not receive any dividends on the shares and his sole source of income for the relevant years were the emoluments he received as managing director of the company. He sought to deduct the interest payment from his income from the employment. The claim was rejected. The court there held that in the context of a statute which had divided income into separate sources, all of which might not yield income in a given year, only those sources which produced income in the year were subject to the charge to tax and that the interest expense, which had nothing to do with the emoluments the taxpayer received from his employment, could not be deducted from that income.

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23 We entirely agree with the decision in ***Thwaites*** . No way could it be argued that in ***Thwaites*** the interest payment had anything to do with the emoluments the taxpayer was earning as the managing director, an employee. To the extent that ***Thwaites*** decided that interest expense may only be deducted from that source of income in respect of which the interest expense was incurred, it is a pertinent case. But it does not provide a complete answer to the present case because what the appellant here contends is that we should look at the real purpose of the overdraft obtained from OCBC.

24 Counsel for the appellant emphasized that under s 10(1)(a) the test is whether the loan is employed for income-producing purposes and not whether the original link between the loan and the assets has been maintained. It does not matter that the assets had changed provided the necessary linkage can be made between the income earned and the maintenance of the overdraft.

25 It seems to us that what counsel for the appellant here is really contending is that one should not merely look at the form, namely, that the overdraft was drawn to pay a debt due to the vendors of the shares in Wan Holdings. One should look at the substance; what is the true nature of the transaction viewed in its totality. While it was true that the Hillview property was distributed to the appellant following the liquidation and that was before the overdraft was drawn to pay for the debt, the fact remains that that payment indirectly brought about the owning by the appellant of the Hillview property. It is only when you look at the entire transaction, involving the two steps, that the link is established; though the acquisition of the Hillview property was not achieved through a direct sale and purchase, the rental income was acquired as the ultimate consequence.

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26 First, we would like to say that we do not think the arguments and the authorities on deferred payments and substituted financing [***Federal Commissioner of Taxation v Marbray Nominees Pty Ltd*** and ***Deputy General of Inland Revenue v Rakyat Berjaya Sdn Bhd***] assist the appellant because the issue here is not really that. There would have been no problem in deduction if the interest incurred were sought to be deducted against dividends derived from the shares. The arguments on those lines would be meritorious if the interest incurred was sought to be deducted from dividend income obtained from Wan Holdings as the overdraft funds were used to repay the debt owing to the vendors of the shares: see ***Federal Commissioner of Taxation v Roberts & Smith*** and ***Yeung v Federal Commissioner of Taxation*** . There is no question of refinancing in so far as the rental income from the Hillview property is concerned. No original funds had been used to earn the rental income from trade. There was no question of such funds being replaced by the overdraft.

27 In ***Federal Commissioner of Taxation v Roberts & Smith*** , a law partnership took out an overdraft to enable it to repay partners the capital they had put into the firm over the years to enable the firm to carry on its business. The object behind this repayment to the partners was to make it cheaper for new partners to buy into the partnership. The full Federal Court of Australia held that the interest paid on the overdraft was deductible as the interest was incurred on a loan used to repay working capital originally advanced from partners. The court rejected the argument that the funds were used for a private purpose, namely, to pay the partners. It is important to note what Hill J said:

> *The funds to be withdrawn in such a case were employed in the partnership business; the borrowing replaces those funds and the interest incurred on the borrowing will meet the statutory description of interest incurred in the gaining or production by the partnership of the assessable income.*

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28 In principle, such a case is no different from the borrowing from one bank to repay working capital originally borrowed from another; the character of the refinancing takes on the same character as the original borrowing and gives to the interest incurred the character of a working expense.

29 In ***Roberts & Smith*** the money borrowed replaced the original funds employed in the same business, which is not the situation in the present case. Here, the original financing by deferred payment was employed in acquiring shares, and thus income in the nature of dividend. The refinancing was to pay the debt due to the vendors of the shares. The overdraft did not replace original funds employed in acquiring income from trade, namely, the rental income.

30 In ***Yeung*** , a husband and wife had contributed moneys to purchase real estates in their names as well as in the names of their children in circumstances which the court held gave rise to a partnership within the meaning of s 6(1) of the Income Tax Assessment Act 1936. The partnership borrowed from a related company and the borrowed funds were used to repay the advances made by the husband and wife. The court held that the interest incurred on the borrowed funds was to be deductible under s 51(1) of the Act. Davies J`s reasoning for his determination was as follows (pp 4204-4205):

> *In an income-earning enterprise, both income and equity capital may be invested in assets directed to the earning of income. In such an event, if equity capital is repaid and loan capital replaces it, interest payable on the loan capital will ordinarily be an allowable deduction from the income derived from the assets. This is because the assets held represent the equity and the loan capital and, if the assets are directed to the earning of income, then both the loan capital and the equity capital which they represent are devoted to the earning of assessable income.*

31 ... In the present case, after the carrying through of the subject transaction, the funds borrowed from Ozanu Pty Ltd were represented in the

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properties owned and leased by the partnership. Therefore, in my opinion, the loan funds should be regarded as having been invested in those properties. As the properties were income earning assets, the conclusion follows, in my opinion, that the moneys are to be regarded as laid out for the purpose of gaining assessable income.

32 In our view ***Yeung*** is really a case of substituted financing. The money provided by the husband and wife to the partnership was treated as an advance. Furthermore, the assets producing the income had remained the same and so had the nature of the income. These differentiate ***Yeung*** from the present case.

33 Reverting to the problem in hand, it seems to us that at the end of the day it is the few key words in the section which are going to decide the matter: `capital employed in acquiring the income.` It is only when the answer to this question, whether the overdraft was employed in acquiring the rental income, is in the affirmative that the interest incurred would be deductible from the rental income. We do not think one should disregard the manner in which the appellant has gone about arranging the transaction. Whatever may be said to be the motive behind the arrangement, there is no denying that the overdraft was used to pay a debt, or the purchase price of the shares from the vendors. It is pertinent to note that the resolution passed by the appellants stated, `That the purchase of 100% equity in Wan Holdings Pte Ltd ... ***for long-term investment purpose*** , thereby making Wan Holdings Pte Ltd a wholly-owned subsidiary of the company, be and is hereby approved.` The overdraft has nothing to do with the acquisition of the Hillview property, except in the remote sense.

34 We endorse the view that under s 14(1)(a) there must be a direct link between the money borrowed and the income produced. In both ***Robert & Smith*** and ***Yeung*** the direct link was there. We accept that business does not operate

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in a `static environment` and that plants and machinery are constantly being sold and replaced while the original loans with the banks remain outstanding. But we do not think this latter example advances the appellant`s case. If one were to examine closely that example there is in fact a direct link between the money borrowed to buy machinery, or replacement machinery, and the income produced. There is no question of any change in the source of the income: the interest incurred on the plant and machinery is clearly to produce income from trade.

35 While it is true that the property was mortgaged to OCBC as security for the overdraft, we do not think that fact alters the fact that the overdraft was utilized to pay off a debt - the shareholders of Wan Holdings. The loan was used to discharge an existing liability. It was so reflected in the balance sheet of the appellant for 1988 (4 RA 125). It would make no difference whether the appellant had used the Hillview property or any other of its property to secure the overdraft.

36 The purchase of the shares did not in itself vest the Hillview property or the rental income in the appellant. They were brought about by an act of the shareholders of Wan Holdings in voluntarily winding-up the company. The original assets which were the shares, and the original income, the dividends, which is a different source of income, had all ceased to exist following the liquidation of Wan Holdings. The overdraft could not be attributable to the acquisition of the rental income.

37 We noted that counsel for the appellant has argued that s 14(1)(a) is concerned with how the capital was employed during the period in which the interest was incurred, not how the capital was employed when first raised or during some other periods. We are here concerned with the question how the

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capital (the overdraft) was employed when first raised; no question concerning subsequent years or periods arises.

38 We also noted the appellant`s contention that the important question is not ***to whom*** the overdraft money was paid but ***for what*** . It is precisely when we addressed this question that we felt that on the facts the money was used to pay a debt due to the vendors of the shares. There can be no doubt about that. The debt was due to the vendor on account of the sale simpliciter. The liquidation of Wan Holdings, and the distribution of the assets of Wan Holdings, were extraneous matters brought about by acts of the shareholders of Wan Holdings.

39 We do not think it is in any sense unjust that no deduction is allowed in the present case. If the appellant had effected the transaction in a more direct manner, the interest incurred would have been tax deductible. But because it wished to save stamp duties, it adopted a circuitous route of buying over the Hillview property from Wan Holdings. This double-step made all the difference. It gave rise to two different sources of income. Thus the missing link. Tax planning is largely a matter of form. While there is nothing improper for the appellant to arrange its affairs which best advanced its interest, having regard to the fact that its ultimate objective was to acquire the Hillview property, it has to bear the consequences of its chosen method.

40 In passing we would mention that arguments have been presented to us as to whether the provisions in s 14(1)(a) is subject to s 15(1)(b) which reads:

> *Notwithstanding the provisions of this Act, for the purpose of ascertaining the income of any person, no deduction shall be allowed in respect of -*

> *(b) any disbursements or expenses not being money wholly and exclusively laid out or expended for the purpose of acquiring the income[.]*

41 In view of the construction we have placed on s 14(1)(a) there is no need for us to go into that.

42 In the result the appeal is dismissed with costs. The security for costs shall be paid out to the respondent to account of costs.

43 ***Appeal dismissed.***

Chao Hick Tin J
Karthigesu JA
L P Thean JA

Nand Singh Gandhi (Nand Singh Gandhi & Co) for the appellant
Julia Mohamed (Inland Revenue Authority of Singapore) for the respondent

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