
Jonathan Chen Yeen Muk, Singapore Management University
SGCA 15

Introduction

The Court of Appeal ("CA") decision in Comptroller of Income Tax v AQQ and another [2014] SGCA 15 (AQQ) is significant for addressing three issues in relation to tax avoidance: (a) The manner in which the tax avoidance provision, ss 33 of the Income Tax Act (Cap 134, 2008 Rev Ed) ("the ITA"), should be applied; (b) the Comptroller of Income Tax's ("the Comptroller") exercise of power under s 33(1) of the ITA, which entitled it to counteract tax advantages obtained; and (c) The Comptroller’s scope of power under s 74(1) of the ITA in relation to the issuance of Additional Assessments.

This note will focus mainly on the first two issues. Whilst the judgment has clarified how s 33 is to be applied as well as clarified the standard of review the High Court should adopt in reviewing the decisions of the Comptroller, several difficulties remain, as will be pointed out.

The facts

Essentially, the case concerned a corporate restructuring scheme and a financing scheme. AQQ was incorporated as part of a corporate restructuring exercise in the B Group. It acquired several subsidiary companies in Singapore by paying $75 million to B, C and D (all related companies under the B group) each, for their interests in those companies.

A financing arrangement for $225 million was entered into and the following material transactions were effected: (a) AQQ raised $225 million by issuing fixed rate notes at an interest rate of 8.85% per annum with a 10 year tenure to N Bank Singapore; (b) N Bank Singapore then sold $205 million of the principal component of the fixed rate notes ("the principal component") to N Bank Mauritius for $205 million cash, with interest payable at 8.845%. It also agreed to deliver the remaining balance of $20 million to N Bank Mauritius at a later date for $20 million cash; (c) N Bank Mauritius then sold to C $205 million of the principal component for $205 million cash, paying C 8.840% interest. It also agreed to deliver the remaining balance of $20 million of Principal Notes to C at a later date for $20 million cash; (d) C received an interest free loan of $75 million from B and D so it could pay for the principal component purchased from N Bank Mauritius.

In the relevant years of assessment, franked dividends were paid out to AQQ under the previous imputation system for Singapore corporate tax. They carried tax credits which could be set off against AQQ’s chargeable income. Interest was also paid by AQQ to N Bank Singapore under the Fixed Rate Notes.

Later, AQQ sought to deduct the interest expense from the dividend income. It also sought to claim the tax credits. Initially, this substantially reduced its tax liability through tax refunds from the Comptroller. However, the Comptroller later formed the view that this amounted to tax avoidance and exercised its powers to disregard both the dividend income and interest expenses which recouped the tax refunds.

AQQ then appealed to the Income Tax Board of Review ("the Board") but the appeal was dismissed. Dissatisfied, AQQ appealed to the High Court.

The High Court decision

At the High Court, AQQ argued that the Board adopted the wrong approach in interpreting and applying s 33 and erred in its conclusion that AQQ had avoided tax. It also argued that the Comptroller was ultra vires in exercising its power under s 74.

Andrew Ang J held that in applying s 33, the Comptroller had to take the following steps: (a) Determine whether the arrangement fell within any of the three limbs in s 33(1); (b) If it did, whether either of the two statutory exceptions in s 33(3) applied to the arrangement. If either did, the Comptroller could not exercise his powers under s 33(1).

Three points of significance in the High Court decision are: (a) Section 33(3)(b) required evidence to be holistically evaluated. Here, while the corporate restructuring was done bona fide for commercial reasons,
the financing arrangement was not and AQQ did not fall within s 33(3)(b); (b) A proper balance between s 33 and the other ITA provisions could be struck by interpreting s 33(1) as importing an objective test, and s 33(3)(b) as importing a purely subjective test. There was no need to choose between the "choice" approach and the "scheme and purpose" approach in Australia and New Zealand respectively; (c) The Comptroller had to exercise his powers fairly and reasonably and treat tax payers fairly. Here, since it was only the financing arrangement and the artificial generating of interest that offended s 33, the Comptroller should not have disregarded AQQ's dividend income, which allowed it to benefit from tax credits.

The Court of Appeal decision

At the CA, the Comptroller appealed the trial judge's decision that it had not acted reasonably and fairly in exercising its s 33(1) powers, while AQQ appealed the trial judge's decision that the financing arrangement amounted to an agreement to avoid tax under s 33(1). The CA held that moving forward, s 33 of the ITA is to be applied in the following manner: (a) Consider whether an arrangement prima facie falls within any of the three threshold limbs of s 33(1) such that the taxpayer derives a tax advantage; and if so, (b) Consider whether the taxpayer may fall under the statutory exception in s 33(3)(b); and if not, (c) Ascertain whether the tax advantage obtained was due to a specific provision in the ITA that was within the intended scope and Parliament's contemplation and purpose, both as a matter of legal form and economic reality within the entire agreement's context.

The interpretation of s 33(1)(c) of the ITA

The first disputed issue was the interpretation of the phrase "to reduce or avoid any liability imposed or would have otherwise been imposed" found in s 33(1)(c), which the trial judge found the financing arrangement fell under.

The CA held that this section must consider the legal nature and characterization of the tax credits attached to the franked dividends. Since s 33(1)(c) included the phrase "would otherwise have been imposed", it was clear that the provision contemplated the situation where liability was to fall on AQQ had there been no financing arrangement. Just because AQQ might not have a net obligation to pay further tax did not preclude a finding of tax avoidance or reduction – this was a question of legal liability, not fact or accounting.

The interpretation of s 33(1)(c) is illuminating because it makes the distinction between a question of legal liability and an issue of fact and accounting. This is a principled approach, distinguishing consequentialism from legal liability. However the onus then falls on lawyers and accountants alike to establish at what point does legal liability arise, or the extent of this legal liability. It also appears to shift the focus to an entity's gross tax liability as opposed to net tax liability in assessing whether tax payable was indeed avoided. Future cases will determine whether this will be the approach moving forward.

The interpretation of s 33(3)(b) of the ITA

To come within the statutory exception to s 33(1) in s 33(3)(b), two requirements must be fulfilled: (1) the arrangement must have been carried out for bona fide commercial reasons and (2) it must not have had as one of its main purposes the avoidance or reduction of tax. The central issue was whether the word "purpose" was to be read objectively or subjectively.

On the facts, it is observed that the application of s 33(3)(b) is highly sensitive to the factual findings. In particular, the CA made specific reference to (1) B Group's public announcement on the Kuala Lumpur Stock Exchange that the Fixed Rate Notes were not intended to affect its consolidated borrowing position, (2) its Chief Financial Officer's admission that there was no coincidence that B Group was able to purchase the Fixed Rate Notes on the same day because it had the money to buy back their bonds from internal funds, and (3) there was no good explanation for the financing arrangement going through N Bank entities in two different jurisdictions. Therefore AQQ fell outside of s 33(3)(b). This does not appear to be contentious on the facts – the circuitous fund transfer arrangement entitling N Bank to merely a 0.01% spread was highly indicative of

The interplay between s 33(3)(b) and other specific provisions of the ITA

The CA considered that s 33(3)(b) was not the only safeguard against an overinclusive application of s 33(1). This approach was not consistent with Parliament's intention that Australian and New Zealand case law would adequately safeguard the right of taxpayers to rely on these incentives. Furthermore, this safeguard was important because s 33 does not expressly allow the application of tax incentive schemes in the ITA. The New Zealand scheme and approach adopted by the majority in Ben Nevis Forestry Ventures Limited and Ors v the Commissioner of Inland Revenue (2009) 24 NZTC 23 was chosen over the Australian choice principle, since it provided a conceptual methodology that combined tax policy and principle in answering the question of whether a taxpayer was entitled to use a specific provision in the ITA in reducing tax liability. The Australian choice principle also appeared to place specific provisions above the general anti-avoidance provision, rendering the general anti-avoidance provision nearly useless. Moreover, the choice principle was now obsolete in Australia.

This point is significant because in approving the scheme and purpose test, taxpayers could now, in addition to the statutory exception in s 33(3)(b), look to specific provisions in the ITA to escape s 33(1)'s potential overreach. However a complication results in that lawyers and accountants would now have to deduce Parliamentary intention in using a specific tax provision. This is not always an easy task, and was acknowledged by the CA. Its difficulty could lead to a greater use of advance tax rulings. One should also note the limitations of the advance tax ruling if used – it only applies to the particular tax payer and the particular arrangement and does not set precedent for later cases.

The standard of review over the Comptroller's findings in s 33 of the ITA

The Comptroller is empowered in s 33(1) to "disregard or vary the arrangement and make such adjustments as he considers appropriate ... so as to counteract any tax advantage". This final issue worthy of comment
concerns the standard of review by courts over the Comptroller's exercise of this power.

The CA held that this standard of review did not mean a full and unconstrained consideration of the merits, and did not warrant that a judge substituted his views over that of the Comptroller. The Comptroller was entitled to act fairly and reasonably, and was entitled to take any practical yardsticks that may enable him to practically exercise this discretionary power. The trial judge, who had embarked on an in-depth assessment of the Comptroller’s treatment of the financing arrangement, was overruled and the Comptroller's findings were left undisturbed.

This holding is significant because the CA has significantly lowered the standard of review over the Comptroller – as long as he acted fairly and reasonably, he was entitled to exercise his discretion in a practical manner. However it remains unclear as to what is the standard the Comptroller is held to – the CA reserved the use of the phrase *Wednesbury unreasonableness*. Does this indicate the a new approach in appellate review over the Comptroller – one which prescribes the standard of fairness and reasonableness, with considerable latitude in to allow for the various factual permutations that might exist? It is suggested that the CA's holding could benefit from greater clarity moving forward.

**Conclusion**

*AQQ* has provided an approach to implementing s 33 of the ITA. However practically it could mean greater difficulty especially when Parliamentary intention is sought. Further clarity would also be welcome where the standard of review of the Comptroller's discretion is concerned. Nevertheless, it is a judgment that removes considerable doubt on the application of a relatively short provision that understates its importance.

* This blog entry may be cited as: Jonathan Muk, "Issues in Tax Avoidance: Comptroller of Income Tax v AQQ [2014] SGCA 15" (25 May 2014)

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