A BIG, FRUSTRATING CONUNDRUM: REFLECTIONS ON SINGAPORE'S DEDUCTION REGIME FOR INTEREST AND OTHER BORROWING COSTS FOLLOWING *BFC v CIT*

In *BFC v Comptroller of Income Tax* [2014] 4 SLR 33, the Court of Appeal provided a clear and practical solution to a conundrum: how to prevent s 14(1)(*a*) of the Income Tax Act (Cap 134, 2014 Rev Ed) from being otiose? However, the solution has no basis, and leads to uncertainty regarding other deduction provisions. Further, one of the principles underlying the conundrum causes confusion regarding the distinction between the deduction and capital allowance regimes and should be discarded. Ultimately, this article argues that comprehensive legislative reform is the best solution to these issues, and makes some suggestions on the shape of the new rules. Lastly, the judgment raises a second, lesser conundrum: whether borrowing costs on working capital loans can ever be deducted.

Justin Jerzy **TAN***
LLB (National University of Singapore);
Advocate and Solicitor (Singapore);
Sheridan Fellow, National University of Singapore.

I. Introduction

1 In the 2014 decision of *BFC v Comptroller of Income Tax*[1] ("*BFC CA*"), the Court of Appeal appeared to have settled the law on the deductibility of borrowing costs, by explaining the relationship between s 14(1)(*a*) and s 15(1)(*c*) of the Income Tax Act[2] ("ITA"). However, a closer examination reveals that the court's explanation was essentially an attempt to resolve a big, frustrating conundrum: how to prevent s 14(1)(*a*) from being otiose? In this article, the author argues that the court's solution, although clear and practical, should be discarded. The search for an alternative solution reveals that one of the principles underlying the conundrum should also be discarded. Ultimately, it will be submitted that comprehensive legislative reform is the best solution to these issues. Lastly, a second, lesser conundrum raised by the judgment in *BFC CA* will be highlighted.

* The author is grateful for the helpful comments from the anonymous referee.
1 [2014] 4 SLR 33.
2 Cap 134, 2014 Rev Ed.

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

2 This article is divided into six parts. Part I contains the introduction[3] and Part VI the conclusion.[4] Part II summarises *BFC CA*, and this includes a summary of the principles underlying our deductibility regime for borrowing costs.[5] Part III discusses the big, frustrating conundrum: what it is, how the court solved it and why the court's solution is unsatisfactory.[6] In Part IV, the author searches for an alternative solution to the conundrum, argues that one of the principles underlying the conundrum should be discarded, and ultimately concludes that the best solution is comprehensive legislative reform.[7] Part V discusses the second, lesser conundrum: can borrowing costs on working capital loans ever be deducted?[8]

II. Summary of *BFC CA*

3 The taxpayer company owned and operated a hotel in Singapore. It wanted to raise money to (a) renovate its hotel; (b) refinance existing borrowings of itself and its subsidiaries; and (c) finance its day-to-day operations.[9] To that end, the company issued bonds in 1995 and 1996.

4 Certain borrowing costs were incurred by the company from the bond issuance. These took the form of interest, discount and redemption premium components.[10]

5 About $36m of the bond proceeds was used to renovate the hotel. The remaining proceeds went into a mixed pool of funds, part of which was income producing and part of which was not. The Comptroller of Income Tax ("Comptroller") allowed deductions on the interest paid on the $36m, and the proceeds that formed the income producing part of the mixed pool of funds.

---

3 See paras 1–2.
4 See para 60 below.
5 See paras 3–15 below.
6 See paras 16–28 below.
7 See paras 29–49 below.
8 See paras 50–59 below.
9 These were findings of fact by the High Court, based on the company's board resolutions, corporate announcement and other related documents around the time that the bonds were issued. See *BFC v Comptroller of Income Tax* [2013] 4 SLR 741 at [85]–[92]. The company did not challenge these findings and so they were accepted by the Court of Appeal: see *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [34].
10 A discount is the difference between the issue price and the face value of the bond. A redemption premium is the difference between the redemption amount and the face value of the bond. Thus, if a bond has a face value of $100, an issue price of $98 and is redeemable (on maturity) at $103, the discount is $2 ($100 – $98) and the redemption premium is $3 ($103 – $100).

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

6 However, the Comptroller disallowed deductions claimed by the company on the discount and redemption premium that were attributable to (a) the $36m spent on renovating the hotel; and (b) the income producing part of the remainder of the bond proceeds that went into the mixed pool of funds (collectively, the "Deduction Claims"). The company's appeal failed at the Income Tax Board of Review, the High Court and the Court of Appeal; *ie*, the Deduction Claims were ultimately rejected.

7 The Deduction Claims failed on two grounds. Firstly, the discount and redemption premium were not "interest", and so could not be deducted under the relevant version of s 14(1)(*a*) of the Income Tax Act[11] which applied only to interest and not other types of borrowing costs.[12] Secondly, on the facts, the discount and redemption premium were capital expenditure and could not be deducted under the general deduction formula in s 14(1) of the ITA.[13]

8 The first ground, that the discount and redemption premium were not "interest" under s 14(1)(*a*), is uncontroversial. The court noted that while commercial men may consider that interest, the discount and redemption premium were all in substance compensation for the use of money, the legislative scheme has greater weight than the views of commercial men. In this regard, the court was of the view that the legislative scheme supported a narrower reading of "interest" for two reasons.[14]

9 Firstly, there is no justification to interpret "interest" broadly, because the general deduction formula in s 14(1) is already phrased broadly. Secondly, "interest" should be interpreted the same way throughout the ITA, unless the context clearly suggests otherwise. In this regard, the ITA as a whole treats "interest" and "discounts" as distinct things. Thus, s 10(1)(*d*) charges to tax certain income in respect of

11 Specifically, the Income Tax Act (Cap 134, 2001 Rev Ed).

12 This was an older version of s 14(1)(*a*) in the Income Tax Act (Cap 134, 2001 Rev Ed), which provided specifically for the deduction of interest. It read (continuing from s 14(1) and describing the type of sum that may be deducted): "(a) except as provided in this section, 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".

13 Section 14(1) reads: "For the purposes 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".

14 *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [46]–[48].

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

"dividends, interest or discounts", implying that "interest" and "discounts" are different things.[15]

10 What then did "interest" under s 14(1)(*a*) mean? The court stated that the essence of interest is compensation for the deprivation of the use or delayed payment of money by another.[16] Not only that. Interest must also accrue with time. In other words, the total amount of interest payable depends on the duration of the loan.[17] The discount and redemption premium did not have this feature, as they were fixed once and for all. Hence, they were not "interest" under s 14(1)(*a*).

11 As mentioned, the court's holding on the definition of interest is unsurprising. The court is bound by s 9A of the Interpretation Act[18] to interpret "interest" purposively.[19] Significantly, the court's holding on the definition of "interest" shows how two payments arising from the same arrangement and which differ more as to form than substance (*ie*, interest on the one hand, and the discount and redemption premium on the other), may have very different tax outcomes. In any event, the current version of s 14(1)(*a*) allows discounts and redemption premiums to be deducted,[20] thus closing any gap between the result in *BFC CA* and the presumed views of commercial men (*ie*, that discounts and redemption premiums should be deductible as they are akin to interest).

---

15 *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [48]. Separately, it is also worth noting that the deemed sourced rule in s 12(6) applies to "any interest, commission, fee, or any other payment in connection with any loan or indebtedness …". While this wording does not explicitly refer to discounts and redemption premiums, these components would fall under "any other payment in connection with any loan or indebtedness". Thus, although s 12(6) explicitly mentions "interest" but not "discount" and "redemption premium", it cannot be said that this requires "interest" to encompass the latter two components.

16 *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [50].

17 *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [49] and [52].

18 Cap 1, 2002 Rev Ed.

19 See also *JD v Comptroller of Income Tax* [2006] 1 SLR(R) 484 at [18].

20 The current version of s 14(1)(*a*) provides specifically for the deduction of interest and other types of borrowing costs. It reads (continuing from s 14(1) and describing the type of sum that may be deducted):

> (*a*) except as provided in this section –
>
> (i) any sum payable by way of interest; and
>
> (ii) any sum payable in lieu of interest or for the reduction thereof, as may be prescribed by regulations (including the restriction of the deduction of the sum in respect of money borrowed before the basis period relating to the year of assessment 2008),
>
> upon any money borrowed by that person where the Comptroller is satisfied that such sum is payable on capital employed in acquiring the income …

Discounts and redemption premiums are prescribed as deductible borrowing costs under items 3 and 4 of the Sched to the Income Tax (Deductible Borrowing Costs) Regulations 2008 (GN No S 115/2008), which were passed pursuant to s 14(1)(*a*)(ii).

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

12 The second ground for the failure of the Deduction Claims involved merely an application of existing law to the facts of the case. Nevertheless, it is useful to discuss the second ground as it provides a summary of the principles and approaches underlying our deductibility regime for borrowing costs, and these principles will be analysed in detail later in this article. The second ground is that on the facts of *BFC CA*, the discount and redemption premium were capital expenditure, and so were not deductible under the general deduction formula in s 14(1). This is because s 15(1)(*c*), which applies notwithstanding the provisions of the ITA, prohibits the deduction of capital expenditure.[21] At the outset, the classification of the discount and redemption premium as capital or revenue expenditure was the same as the classification of the underlying loan's purpose; *ie*, the capital or revenue purpose for which the bonds were issued, objectively determined at the time of issue, unless there was a change in purpose. If the purpose was revenue in nature, the discount and redemption premium would be revenue in nature. Conversely, if the purpose was capital in nature, the discount and redemption premium would be capital in nature.[22]

13 In order to ascertain the purpose of the bond issuance, the court applied the approach set out by the Court of Appeal in *Comptroller of Income Tax v IA*[23] ("*IA*"). This approach is as follows[24] ("*IA Approach*"):

> (a) Ascertain if there is a sufficient linkage or relationship between the loan and the main transaction or project for which the loan was undertaken.
>
> (b) If, in (a) above, no, or an insufficient, linkage is established, the purpose of the loan must be merely to add to the capital structure of the taxpayer and is thus capital in nature.
>
> (c) If there is a sufficient linkage between the loan and the main transaction for which the loan was undertaken, ascertain whether the main transaction is itself capital or revenue in nature; and the purpose of the loan will follow the nature of this main transaction.

---

21 Section 15(1)(*c*) 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 –
>
> …
>
> (*c*) any capital withdrawn or any sum employed or intended to be employed as capital except as provided in section 14(1)(*h*); ….

Section 14(1)(*h*) is not relevant to the deductibility of borrowing costs.

22 *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [28]–[29].

23 [2006] 4 SLR(R) 161.

24 *Comptroller of Income Tax v IA* [2006] 4 SLR(R) 161 at [79].

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

14 Applying the *IA Approach*, the court in *BFC CA* made the following holdings.[25] The first purpose of renovating the hotel was capital in nature since the hotel was a capital asset; *ie*, it was part of the company's permanent business structure. The second purpose was to refinance the existing loans of the company and its subsidiaries. This purpose was also capital in nature because there was no indication that the loans that were refinanced were linked to a main transaction that was revenue in nature. Lastly, the third purpose of financing the day-to-day operations of the company was capital in nature as well. This was because the company did not show any sufficient linkage or relationship between that part of the bond proceeds applied towards the third purpose, and a main transaction of a revenue nature.

15 Since all the purposes of the bond issuance were capital in nature, the bonds were capital in nature. Following from that, as the discount and redemption premium were derivative of the bonds, they shared the same classification as the bonds. In other words, they were capital in nature, and prohibited by s 15(1)(*c*) from deduction under s 14(1).

III. A big, frustrating conundrum: How to prevent s 14(1)(*a*) from being otiose?

16 The most important parts of the judgment in *BFC CA* did not actually affect the outcome of the case. They relate to the court's ruling on the proper relationship between s 14(1)(*a*) and s 15(1)(*c*). In effect, the court provided a solution to a conundrum: how to prevent s 14(1)(*a*) from being otiose? This conundrum and how the court's ruling solved it are not apparent from the judgment in *BFC CA*, because the court never explicitly acknowledged the conundrum in the first place.

A. What the conundrum is and how the court solved it

17 We first examine what the conundrum is. As discussed above, where the borrowing cost is capital in nature, it is not deductible under s 14(1) read with s 15(1)(*c*), because s 15(1)(*c*) applies notwithstanding the provisions of the ITA.

18 However, a difficulty arises when we read s 14(1)(*a*) together with s 15(1)(*c*). Section 14(1)(*a*) provides for the deduction of a borrowing cost that is "payable on capital employed in acquiring the income". The word "capital" refers to a loan that is capital in nature.[26]

25 *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [35].

26 See, for example, *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [41] which, when discussing the effect of s 14(1)(*a*), implied that "capital" in s 14(1)(*a*) referred to a loan that is capital in nature.

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

Where the underlying loan is capital in nature (because its purpose is capital in nature), the borrowing cost is capital in nature. The issue is that, as mentioned above, s 15(1)(*c*) prohibits taking a deduction on a borrowing cost that is capital in nature, and s 15(1)(*c*) applies notwithstanding the provisions of the ITA. If this is the case, s 14(1)(*a*) in effect has no application, because in every situation where the loan is capital in nature (which is a requirement under s 14(1)(*a*)), the borrowing cost relating to that loan will also be capital in nature, and thus prohibited from deduction under s 15(1)(*c*). Clearly, it is abhorrent for the entire s 14(1)(*a*) to be otiose. This, then, is the conundrum: how to prevent s 14(1)(*a*) from being otiose?

19 In *T Ltd v Comptroller of Income Tax*[27] ("*T Ltd CA*"), the Court of Appeal seemed to resolve this conundrum as follows.[28] Once the borrowing cost is payable on a loan that is capital in nature (*ie*, to acquire a capital asset), and that capital asset produces income (which is a requirement for deduction under s 14(1)(*a*)), then the borrowing cost becomes revenue in nature. Almost by definition, all deductions under s 14(1)(*a*) thus become revenue in nature, and so the prohibition in s 15(1)(*c*) does not apply. This explanation ("Original Solution") was derived from *obiter dicta* in the Privy Council case of *Wharf Properties Ltd v Commissioner of Inland Revenue (Hong Kong)*[29] ("*Wharf*"). The basis of the Original Solution is that a borrowing cost incurred in the same period as the income produced by the capital asset is part of the cost of generating the income, and is thus a revenue expense. However, in the light of other passages in the judgment in *T Ltd CA*, it was unclear whether the court was actually putting forward the Original Solution. Consequently, the court in *BFC CA* sought to clarify this.

20 The court in *BFC CA* rejected the Original Solution. It held that the borrowing cost remains capital in nature even after the capital asset (that was acquired using moneys from the underlying loan) is employed in acquiring income. Instead, the court resolved the conundrum by holding that s 14(1)(*a*) carves out an exception to s 15(1)(*c*), such that a borrowing cost that is capital expenditure may be deducted under s 14(1)(*a*) only if the underlying loan is used to purchase or develop a capital asset, and that capital asset is employed in acquiring income ("Carve Out").[30]

21 In short, the relationship between s 14(1), s 14(1)(*a*) and s 15(1)(*c*) is as follows: if a loan is taken for the purpose of purchasing or developing a capital asset, the related borrowing cost is capital

27 [2006] 2 SLR(R) 618.
28 *T Ltd v Comptroller of Income Tax* [2006] 2 SLR(R) 618 at [24].
29 [1997] MSTC 11,025.
30 *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [39].

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

expenditure and so is not deductible under s 14(1) read with s 15(1)(*c*), unless and until that capital asset is employed in acquiring income, in which case the borrowing cost is deductible under s 14(1)(*a*).

22 The Carve Out is desirable for two reasons. Firstly, the court was correct in rejecting the Original Solution. Although it did not provide a basis for rejecting the Original Solution, the court could have in mind an argument on the following lines. The basis of the Original Solution is that, when the capital asset generates income, the borrowing costs underlying the loan that was used to purchase the capital asset becomes part of the cost of generating that income, and are thus revenue in nature. This is incorrect. Where the underlying loan is taken to acquire the capital asset, the borrowing costs are not part of the cost of generating the income. This is because the borrowing costs are payable regardless of whether any income is generated by the capital asset. Just as capital expenditure in the form of monthly instalments to acquire plant and machinery does not become revenue in nature when the plant and machinery generates income (because the expenditure relates to the plant and machinery, not the income *per se*), so it should be with the borrowing costs.

23 Secondly, the Carve Out is a clear and practical solution to the conundrum: it ensures that s 14(1)(*a*) is not rendered otiose. This is crucial because under the *IA Approach*, the situations where borrowing costs are revenue in nature and thus deductible under the general deduction formula in s 14(1) are arguably rare.[31] Therefore, businesses must often rely on the specific deduction provided in s 14(1)(*a*) to deduct borrowing costs that are capital in nature; *ie*, on underlying loans taken out to fund the acquisition of a large range of capital assets (*eg*, plant and machinery, or land on which to build a factory or mall for rental, *etc*). With the Carve Out, the court effectively affirmed that such borrowing

31 *Comptroller of Income Tax v IA* [2006] 4 SLR(R) 161 itself was one such rare case. In this case, a property development company took a syndicated four-year fixed term loan to fund the acquisition of land and the development of a condominium on that land. It sought to deduct service fees paid to the underwriter and arranger of the loan, as well as guarantee expenses and pre-payment penalties (incurred in relation to paying back the loan fully before the four years ended). Since all these expenses were not deductible under the older version of s 14(1)(*a*) (see n 12 for the exact wording of the provision), the issue was whether they were deductible under s 14(1). The Court of Appeal held that they were revenue in nature and hence deductible. This was because the purpose of the loan was to acquire trading stock (a point the Comptroller conceded); *ie*, to fund the acquisition of the land and the subsequent development of the condominium units on it, which would then be sold. Other examples from case law of borrowing costs that are revenue in nature include: (a) where the underlying loan is used to purchase raw materials (this is implied in *Comptroller of Income Tax v IA*, since on the particular facts of that case, the land on which the condominium was built is analogous to raw materials); and (b) interest payments made to a taxpayer's supplier each time a delivery is made, with the taxpayer then having to pay the bank back within a certain number of days (*BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [33]).

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

costs may be deducted under s 14(1)(*a*) despite s 15(1)(*c*), so long as the capital asset is employed in acquiring income.

B. Issues with the Carve Out

24 The obvious issue is: what is the basis for the Carve Out? Prior to its rejection in *BFC CA*, one could say that the Original Solution was satisfactory if only because it did not contradict the "notwithstanding" wording in s 15(1)(*c*). In contrast, the Carve Out contradicts the "notwithstanding" wording without any basis.

25 A comparison can be drawn to *JD v Comptroller of Income Tax*[32] ("*JD*"). In *JD*, an investment holding company borrowed money to invest long term in many different share counters. Some of the investments did not yield dividend income every year or at all. The company sought to deduct the total interest expenses incurred on the borrowings, against total dividend income earned from the investments as a whole. The Court of Appeal rejected the claim. It reasoned that, since s 14(1)(*a*) contained the words "in acquiring the income", this must mean that the interest expense attributable to a share counter (*ie*, interest incurred in relation to borrowed money that was used to purchase the share counter) can only be deducted against dividend income from that share counter.[33] No deduction is available if the share counter did not produce dividend income. In short, the word "the" requires a link to be established between the interest paid and a specific income, not just any income. Otherwise, the word "the" would be meaningless, which would contradict the principle that every word in a statute is there for a reason. If this principle applies to a single word ("the"), *a fortiori* the Carve Out is unsatisfactory because it effectively contradicts, without any basis, the "notwithstanding" wording in s 15(1)(*c*).

26 The lack of a basis for the Carve Out creates significant uncertainty over whether other deduction provisions under Pt V of the ITA (and there are many of them)[34] could, like s 14(1)(*a*), prevail to a greater or lesser degree against the prohibited deduction items under s 15(1) (of which s 15(1)(*c*) is but one). On the other hand, if the court had provided a basis for the Carve Out, one could apply the same or a similar basis, to better determine by analogy if some other deduction provision (besides s 14(1)(*a*)) could prevail against the s 15(1) prohibitions.

---

32 [2006] 1 SLR(R) 484.
33 *JD v Comptroller of Income Tax* [2006] 1 SLR(R) 484 at [43]–[48].
34 The specific deduction provisions are found in ss 14(1)(*a*)–14(1)(*h*), and ss 14A–14X (although there are several repealed sections like ss 14G and 14J).

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

27 We can speculate that the court deliberately avoided providing a basis for the Carve Out, simply because there is no good basis, and it believed it better to offer no basis than a poor one. One possible but ultimately poor basis is the maxim of statutory construction *generalia specialibus non derogant*, meaning that general provisions will not abrogate special provisions. Thus applied, the more specific deduction provision in s 14(1)(*a*) should prevail against the general prohibition in s 15(1)(*a*).

28 However, this maxim merely helps resolve the deadlock when two provisions seem to contradict each other without the legislation specifying which is to prevail against the other in the event of contradiction. This is not the case here, as s 15(1)(*c*) explicitly states that it applies notwithstanding the provisions of the ITA. Consequently, applying the maxim, without guidance as to the circumstances under which it can be used to defeat a "notwithstanding" provision, does not help resolve the uncertainty over whether other deduction provisions under Pt V of the ITA can prevail against the prohibited deduction items under s 15(1).

IV. Search for an alternative solution to the conundrum

29 We have seen that the Carve Out is an unsatisfactory solution to the conundrum of preventing s 14(1)(*a*) from being otiose because (a) it contradicts the "notwithstanding" wording in s 15(1)(*c*) without any basis; and (b) it leads to significant uncertainty over whether other deduction provisions under Part V of the ITA could, like s 14(1)(*a*), prevail to a greater or lesser degree against the prohibited deduction items under s 15(1). In this Part, alternative solutions to the conundrum (*ie*, besides the Carve Out) will be considered. This necessarily entails examining the underlying principles that give rise to the conundrum, and a consideration of alternative principles under which the conundrum would not arise. It will then be shown that one of the underlying principles, when taken to its logical conclusion, creates significant confusion regarding the distinction between the deduction and capital allowance regimes in the ITA. Finally, to resolve the conundrum and the confusion regarding the deduction/capital allowance distinction, the author suggests that comprehensive legislative reform is the best solution.

30 At the outset, we cannot resolve the conundrum simply by adopting a different interpretation of the literal words of s 14(1)(*a*). To recap, s 14(1)(*a*) allows taking a deduction on a borrowing cost that is payable on "capital employed in acquiring the income". Section 15(1)(*c*) disallows a deduction in respect of a "sum employed or intended to be employed as capital". To illustrate the similarity with s 14(1)(*a*), one may simply replace the words in italics with "capital", with the result that

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

s 15(1)(*c*) disallows deductions in respect of "capital". One might then ask whether "capital" in s 14(1)(*a*) could mean something else, namely: (a) merely the principal amount of the loan *per se* (without any connotation as to whether the loan is capital or revenue in nature); or (b) the capital asset itself (that was acquired using the loan moneys).

31 Both alternative meanings are unsatisfactory. The meaning in (a) is not consistent with the context in which "capital" appears. Firstly, "capital" has a specific connotation in the ITA; it is used in the sense of "other than income or revenue", not "the principal amount of a loan". Secondly, s 14(1)(*a*) already refers to the principal amount of the loan a few words before "capital". The words used are "money borrowed by that person".[35] Therefore, if the intention was to refer to the principal amount of the loan, words like "such money borrowed by that person" would have been used, not "capital". The meaning in (b) has the same effect as interpreting "capital" as a loan that is capital in nature (*ie*, the present interpretation), since if the loan moneys are used to acquire a capital asset, the loan itself is capital in nature.

32 Since we cannot reinterpret "capital" in s 14(1)(*a*) to resolve the conundrum, the search for an alternative solution necessarily entails examining the underlying principles that lead to the conundrum. In the process, we will also consider alternative principles under which the conundrum would not arise.

33 On a plain reading of s 14(1)(*a*) and s 15(1)(*c*), the conundrum is not immediately apparent. Indeed, this is because it relies on two prior assumptions. The first assumption is that a borrowing cost may be capital or revenue in nature. The second assumption is that s 15(1)(*c*) prohibits the deduction of a borrowing cost that is capital in nature. Both assumptions were laid down as legal principles (the "First Principle" or "*Wharf* Principle" and the "Second Principle" respectively; and collectively the "Two Principles") by the Court of Appeal in *T Ltd CA*, approved in *IA*,[36] and are now even more firmly entrenched following *BFC CA*.[37]

34 The First Principle underlies the *IA Approach*. In full, it states: a borrowing cost has the same nature (*ie*, capital or revenue in nature) as the underlying loan, and the nature of the loan is determined by the purpose for which it was taken (*ie*, whether it was for a capital or revenue

35 To revisit the wording of s 14(1)(*a*), the provision allows the deduction of a borrowing cost, *ie*, a sum that is payable "upon any money borrowed by that person", where the Comptroller is satisfied that the borrowing cost is "payable on capital employed in acquiring the income".

36 See *Comptroller of Income Tax v IA* [2006] 4 SLR(R) 161 at [15]–[16].

37 See *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [30] (endorsing the First Principle) and at [28] (implicitly endorsing the Second Principle).

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

purpose). This principle was laid down in *Wharf* and then adopted in *T Ltd CA*.[38]

35 In *Wharf*, the company planned to redevelop an old tramway depot at Causeway Bay in Hong Kong into a commercial complex known as Times Square. It took loans from various financial institutions to fund the acquisition of the tramway depot. As part of the acquisition, it received licence fees from the seller for about two years, after which the seller vacated the premises and work on Times Square began. The issue was whether the company could deduct interest incurred on the loans during those two years.[39] The relevant Hong Kong legislation allowed for interest deductions in certain circumstances, but not if the interest was capital in nature.

36 The Privy Council held that the interest was not deductible as it was capital in nature. The interest payments were for a capital purpose since they were consideration for the use of money which enabled the company to acquire the tramway depot and hold it pending its conversion by redevelopment into an income-earning asset.

37 Further, the Privy Council held that an interest payment may be capital or revenue in nature, depending on the purpose for which it was paid, which necessarily involves determining the purpose of the loan. As a starting point, it was uncontroversial that the moneys spent to acquire the tramway depot in this case were capital expenditure.[40] The question was thus: how should the interest incurred to acquire the moneys spent (*ie*, the loan amount) be characterised? In this regard, the Privy Council reasoned that interest is merely the cost of hiring money, and can be analysed just like any other cost. Thus, the cost of hiring money to rebuild a house (that is intended to be a capital asset) is just as much a capital cost as the cost of hiring labour to do the rebuilding.

---

38 See *T Ltd v Comptroller of Income Tax* [2006] 2 SLR(R) 618 at [24]. The issue in this case was whether a company that developed a shopping mall could deduct expenses including interest, that were incurred prior to the mall being issued a Temporary Occupation Permit (which would enable it to start renting out units). The court held that the company could not claim the deductions, as it had not established an income-generating asset or income-earning structure, *ie*, the expenses were incurred before the commencement of business. Although that was sufficient to resolve the case, the court also considered the relationship between s 14(1)(*a*) and s 15(1)(*c*).

39 For completeness, the Hong Kong tax authorities had allowed a deduction from the licence fees of an equivalent amount of interest. This sum was relatively small, so the remaining interest which the company contended was deductible represented most of the interest.

40 Under Singapore law, the moneys spent would likewise be capital expenditure, under the test for capital expenditure laid down in *ABD v Comptroller of Income Tax* [2010] 3 SLR 209.

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

38 Taking the example of rebuilding a house further, it is clear that interest is not as directly linked to the capital purpose (*ie*, the rebuilding of the house) as the usual type of cost such as the labour cost is. After all, the consideration for paying the labourer is the rebuilding work itself, while interest is one step removed, since the consideration for paying interest is obtaining the loan amount, and only then are the loan moneys applied toward the rebuilding work. However, from the Privy Council's perspective, this only supported its view that the nature of the interest payment follows the purpose for which the loan was taken, because there was no other way in which the nature of the interest could be discovered.

39 From the above discussion, it may be said that the *Wharf* Principle, *ie*, a borrowing cost has the same nature as the underlying loan, and the nature of the loan is determined by its purpose, is a logical answer to the question of whether a borrowing cost is capital or revenue in nature.[41] But it is not the only principle that the Singapore courts could have chosen. A different principle was adopted by the High Court in *T Ltd v Comptroller of Income Tax*[42] ("*T Ltd HC*"). This principle was set out by the High Court of Australia in *Steele v DFC of T*[43] ("*Steele*"). The court in *Steele* chose not to follow the *Wharf* Principle. Instead, it held that an interest payment is ordinarily revenue in nature, because it is ordinarily a recurrent or periodic payment which secures, not an enduring advantage, but rather the use of the borrowed money during the term of the loan. The court in *T Ltd CA*, however, chose to follow the *Wharf* Principle instead of the principle in *Steele*. It reasoned that *Steele* was less persuasive because the distinction between capital and revenue expenditure was not a critical one in Australian tax law, but it was in Singapore.[44]

40 The *Wharf* Principle, by itself, does not result in the conundrum. After all, s 15(1)(*c*) does not explicitly refer to borrowing costs. For the conundrum to arise, s 15(1)(*c*) must prohibit the deduction of a borrowing cost that is capital in nature. This is the Second Principle. The issue of whether s 15(1)(*c*) was intended to be applied to interest was extensively analysed in *T Ltd HC*.[45] The High Court concluded that it was not, for the following reasons:

---

41 For avoidance of doubt, as discussed in the preceding paragraphs, *Wharf Properties Ltd v Commissioner of Inland Revenue (Hong Kong)* [1997] MSTC 11,025 only dealt explicitly with interest payments and not all types of borrowing costs, since the relevant Hong Kong legislation concerned interest payments only. However, there is no reason why the *Wharf* Principle should not be extended to all types of borrowing costs. Thus, the Court of Appeal in *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [31] explicitly stated that the *Wharf* Principle applies to all types of borrowing costs, not just interest payments.

42 [2005] 4 SLR(R) 285.

43 99 ATC 4,242.

44 *T Ltd v Comptroller of Income Tax* [2006] 2 SLR(R) 618 at [23].

45 See *T Ltd v Comptroller of Income Tax* [2005] 4 SLR(R) 285 at [51]–[69].

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

(a) *Wharf* may be distinguished on the basis that the relevant Hong Kong legislation prohibited deducting "any expenditure of a capital nature". This wording can be easily applied to prohibit the deduction of borrowing costs that are capital in nature.

(b) In contrast to the Hong Kong legislation, the wording of s 15(1)(*c*) prohibits a deduction in respect of a sum employed as capital. This wording does not lend itself easily to borrowing costs, which are sums in respect of another sum (*ie*, the principal amount of the loan) employed as capital.

(c) The drafter of the ITA in its original form intended a broad deduction regime for interest. To elaborate, the drafter R B Heasman, in his 1947 report titled *Income Tax: A Report to Their Excellencies the Governors of the Malayan Union and Singapore, with Recommendations, including a Draft Bill and Proposals for Administration and Staffing*, stated that: "Certain deductions are mentioned specifically, *eg*, interest on borrowed money used in the business …." Thus, s 15(1)(*c*) as originally drafted was "subject to the express provisions of the Ordinance". In 1979, s 15(1) was amended. Amongst other changes, the various prohibition items in its sub-paragraphs were to be applied notwithstanding the provisions of the ITA. Although s 15(2) saved several deduction items, it did not save s 14(1)(*a*); and in any event the saving was only in respect of the application of ss 15(1)(*b*) and 15(1)(*d*). The legislative intention of amending s 15(1) was to disallow expenses in respect of a motor car which was not a business service passenger vehicle. The court in *T Ltd HC* reasoned that there was no need to save s 14(1)(*a*) from the "notwithstanding" wording in s 15(1)(*c*) because s 15(1)(*c*) in both forms (*ie*, both before and after the 1979 amendments) was never intended to apply to interest.

41 In *T Ltd CA*, the Court of Appeal overruled the High Court. It reasoned that the words in s 15(1)(*c*), which prohibited a deduction in respect of a sum employed as capital, were actually broad enough to mean that there could be no deduction of interest in respect of that sum. As a result, s 15(1)(*c*) prohibits the deduction of a borrowing cost that is capital in nature. The Two Principles thus result in s 14(1)(*a*) being otiose, since there is no situation where a borrowing cost qualifies for deduction under s 14(1)(*a*) (which presupposes that it is capital in nature), without also being prohibited from deduction under s 15(1)(*c*).

42 At this juncture, it is important to note that a strong argument can be made for discarding the *Wharf* Principle entirely, even if it did not

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

lead to the conundrum. It was stated in *BFC CA*[46] that, if a loan is taken out to acquire a capital asset or to acquire or enlarge the permanent structure of the business, all borrowing costs arising from that loan (*eg*, interest, agency fees, *etc*) will be part of the overall cost of the capital asset or acquiring or enlarging the permanent structure of the business (as the case may be). Indeed, this is the logical conclusion of the *Wharf* Principle.[47] However, the court may have implicitly approved adding borrowing costs to the cost of acquiring plant and machinery, and then claiming capital allowances on the aggregate cost, under s 19 or 19A of the ITA.

43 In other words, even if a borrowing cost is capital in nature, and cannot qualify for deduction under s 14(1)(*a*), a tax benefit may still be obtained by claiming this cost as part of capital allowances available on plant and machinery, albeit not all at once (as in the case of expenses) but spread over a prescribed period.[48] One wonders if the *Wharf* Principle actually intended for borrowing costs that are capital in nature to enjoy capital allowances. The conceptual distinction between deducting borrowing costs and claiming capital allowances on them as part of the overall cost of a capital asset touches on something fundamental to the entire ITA, namely, the distinction between the deduction and capital allowance regimes (which are found in Pt V and Pt VI of the ITA respectively). As the *Wharf* Principle creates significant confusion regarding this distinction, we should discard it.

44 A pause here to take stock is timely. In searching for an alternative solution to the conundrum (as the Carve Out is unsatisfactory), we have seen that the Two Principles underlie the conundrum and that the *Wharf* Principle creates confusion regarding the distinction between the deduction and capital allowance regimes ("Confusion with the Capital Allowance Regime Problem"). We have also seen that the court in *T Ltd HC* had put forward alternative principles (*ie*, the principle in *Steele*, and discarding the Second Principle so that s 15(1)(*c*) does not apply to borrowing costs at all) under which the conundrum and the Confusion with the Capital Allowance Regime Problem would not arise. However, these alternative principles were rejected in *T Ltd CA*. In the discussion below, some observations will be made about the alternative solution.

---

46 *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [30]–[31].

47 See the reasoning for the *Wharf* Principle at paras 37–38 above.

48 Incidental expenses that have a direct nexus with the installation or erection of plant or machinery are part of the overall cost of the plant or machinery, and capital allowances may be claimed on this overall cost. See *Inland Revenue Commissioners v Barclay, Curle & Co Ltd* (1968) 45 TC 221; and the Inland Revenue Authority of Singapore's e-Tax Guide, "Machinery and Plant: Section 19/19A of the Income Tax Act" at paras 6.1–6.2.

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

45 At first glance, judicial intervention appears to be an attractive solution. Although the Two Principles are firmly entrenched following *T Ltd CA*, *IA* and *BFC CA*, the Court of Appeal could, in an appropriate future case, discard the Carve Out and the Two Principles in favour of the approaches taken in *T Ltd HC*. After all, the Court of Appeal has the power to overrule or depart from its previous decisions and has in fact done so on some occasions.[49] However, judicial intervention presupposes that, at some unknown future time, an appropriate case on the deductibility of borrowing costs will arise at the Court of Appeal level. It is unwise to wait for this hypothetical case, since the issues created by the Carve Out and the Confusion with the Capital Allowance Regime Problem are significant enough to warrant a more timely solution.

46 Further, any judicial intervention is constrained by the legislative scheme. Suppose the Court of Appeal wanted to follow *T Ltd HC* by adopting the principle in *Steele* and saying that s 15(1)(*c*) does not apply to borrowing costs. It would still have to explain how these alternative principles interact with the wording in s 14(1)(*a*). *T Ltd HC* did not discuss in detail how the reference to "capital" in s 14(1)(*a*) fits in with the principle in *Steele* that interest is generally revenue in nature.[50] Therefore, since judicial intervention may not be timely enough, and is ultimately constrained by the legislative scheme, we are left with legislative reform as the best alternative solution.

47 How should the legislation be reformed? If it is desired that the legislative changes be minimal, one obvious method is to revert to the pre-1979 version of s 15(1)(*c*). The provision will no longer prevail notwithstanding s 14(1)(*a*); instead, it would be "subject to" s 14(1)(*a*). Section 14(1)(*a*) will not be otiose as it can operate independently of s 15(1)(*c*), and the conundrum goes away.

---

49 For an account of such occasions, see Lau Kwan Ho, "The 1994 Practice Statement and Twenty Years On" [2014] Sing JLS 408.

50 A point of interest. As discussed at paras 30–31 above, the most reasonable meaning of "capital" in s 14(1)(*a*) is a loan that is capital in nature. Without the *Wharf* Principle, borrowing costs no longer share the same nature as their underlying loans. Thus, it is theoretically possible for borrowing costs to be ordinarily revenue in nature under the principle in *Steele v DFC of T* 99 ATC 4,242, even if their underlying loans are capital in nature. Of course, a larger issue then comes to mind: why then do we have to distinguish between loans of a capital nature and loans of a revenue nature in the first place?

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

48 Indeed, it has been noted elsewhere[51] that in practice, the Comptroller already views the specific deductions in ss 14(1)(*a*)–14(1)(*h*) as exceptions to the prohibitions in s 15(1). There is much to be said for this approach; indeed, if this were not the case, a completely different provision, s 14(1)(*g*), would likewise be otiose.[52] Therefore, reverting to the pre-1979 position merely aligns the legislation with the Comptroller's practice. If s 15(1)(*c*) were "subject to" s 14(1)(*a*), there would still be a meaningful difference between s 14(1) and s 14(1)(*a*): borrowing costs that are revenue in nature would be deducted under s 14(1) without having to show a "direct link" to a particular income stream; this, however, is required for borrowing costs that are capital in nature to be deducted under s 14(1)(*a*).[53]

49 However, reverting to the pre-1979 version of s 15(1)(*c*) does not go far enough because it does not abolish the *Wharf* Principle, and so the Confusion with the Capital Allowance Regime Problem remains. We have seen that the *Wharf* Principle is at the core of the deduction regime for borrowing costs. Therefore, the logical solution to both the conundrum and the Confusion with the Capital Allowance Regime Problem is comprehensive legislative reform, *ie*, introducing new rules in place of the *Wharf* Principle. In this regard, the following are a few comments on the shape these new rules may take.

(a) The key policy goals regarding the deductibility of borrowing costs should first be identified. This will include consideration of whether the principle in *Steele*, that borrowing costs are generally deductible, should be adopted. The new rules can then be drafted to achieve those goals. In this regard, it appears that the Government's key policy goal is that borrowing costs that are incurred before the commencement of business

---

51 Poh Eng Hin, "Deduction of Interest and Other Borrowing Costs in Singapore: A Review of the Principles Set Out in Three Recent Court of Appeal Decisions" (2014) 20(6) *Asia-Pacific Tax Bulletin* 438 at 443.

52 See Poh Eng Hin, "Deduction of Interest and Other Borrowing Costs in Singapore: A Review of the Principles Set Out in Three Recent Court of Appeal Decisions" (2014) 20(6) *Asia-Pacific Tax Bulletin* 438 at 443. Section 14(1)(*g*) provides specifically for the deduction of certain religious dues. It would be otiose because s 15(1)(*c*) (which applies notwithstanding s 14(1)(*g*)) prohibits deducting sums that were not expended for the purpose of acquiring income.

53 This point is examined at paras 58–59 below, in relation to the deductibility of borrowing costs incurred on working capital loans.

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

should not be deductible except in limited cases.[54] Thus, the new rules could say that borrowing costs are always deductible unless they are incurred before the commencement of business.

(b) The legislative reform should resolve a second conundrum: can borrowing costs on working capital loans ever be deducted? This issue is discussed in Part V below.[55]

(c) The legislative reform could also take into account how the provisions of the ITA interact as a whole. For example, how should s 15 interact with the specific deduction provisions in ss 14(1)(*a*)–14(1)(*h*), and ss 14A–14X? Further, it is puzzling why deductions for research and development expenditure (which is capital expenditure) are allowed under Pt V of the ITA relating to expenses, instead of Pt VI of the ITA relating to capital expenditure. Obviously, clarifying all these issues is a much wider undertaking.

V. Another conundrum: Whether borrowing costs on working capital loans can ever be deducted?

50 The judgment in *BFC CA* raises a second, albeit lesser, conundrum: can borrowing costs incurred on working capital loans ever be deducted? In short, the *IA Approach* unintentionally creates uncertainty over whether such costs can ever be deducted. While this is an important issue in its own right since working capital loans are common, it will be discussed at the end of this article. This is because the legislative reform suggested above if implemented will necessarily affect the *IA Approach*, as the *IA Approach* is based on the *Wharf* Principle.

---

54 See *Singapore Parliamentary Debates, Official Report* (12 November 2007), vol 83 at cols 2591–2592 (Gautam Banerjee, Nominated Member of Parliament) and col 2595 (Lim Hwee Hua, Minister of State for Finance). Subsequently, in 2011, s 14U was enacted to allow for deductions of expenses incurred prior to the commencement of business, but this provision does not apply to the business of making investments carried out by companies; in fact, it is aimed at start-ups. That expenses incurred before the commencement of business generally cannot be deducted is also the case law position: see *T Ltd v Comptroller of Income Tax* [2006] 2 SLR(R) 618.

55 See paras 50–59 below.

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

51 The court in *BFC CA* hinted that borrowing costs incurred on a working capital loan may be revenue in nature, and so deductible under s 14(1).[56] This is unsurprising since the moneys from such loans are often used to pay trade creditors. However, the court also held that on the facts of *BFC*, the third purpose of the bond issuance (*ie*, to finance day-to-day operations or working capital needs) was capital in nature and so the relevant borrowing costs were capital in nature.[57] This was because under the *IA Approach*, the relevant bond proceeds could not be linked to a main transaction for which the loan was taken and so merely added to the taxpayer's capital structure. After all, a working capital loan is taken out for a wide variety of purposes. It cannot be linked to a main transaction for which the loan was taken.

52 The uncertainty over the nature of a working capital loan has a very practical impact. Specifically, borrowing costs that are revenue in nature would be deductible under s 14(1) if the object of the borrowing costs was to increase overall profitability, which is relatively easy to show.[58] The requirement in s 14(1)(*a*) is stricter. To show that the borrowing costs were payable on "capital employed in acquiring the income" under s 14(1)(*a*), a "direct link" is required between the income and a loan of a capital nature (on which the borrowing cost is incurred).[59] This "direct link" requirement was established in *Andermatt Investments Pte Ltd v Comptroller of Income Tax*[60] ("*Andermatt*"). It requires us to trace the borrowing costs to a loan, the loan to a capital asset acquired by the loan, and then the capital asset to income.

53 The difficulty is obvious. If a working capital loan cannot be sufficiently linked to a main transaction for which the loan was taken, how can the borrowing costs on that loan ever be "directly linked" to a capital asset which then produces the income? In fact, a working capital loan, almost by definition, can never be linked to a capital asset.

54 Three different approaches to resolve this conundrum regarding the deductibility of borrowing costs incurred on working capital loans are suggested here. These approaches assume that the state of the law is as it

56 The court stated (*BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [33]), by way of example, that an interest payment is revenue in nature if it was payable to a bank that pays the taxpayer's supplier each time a delivery is made, with the taxpayer then having to pay the bank back within a certain number of days. The payment arrangement in this example is quite similar (in terms of purpose and use of moneys) to a working capital loan.

57 *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [35].

58 This is the "wider nexus test" to fulfil the requirement that the borrowing costs were "wholly and exclusively incurred … in the production of the income". See *Comptroller of Income Tax v IA* [2006] 4 SLR(R) 161 at [98]–[100] and *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [43].

59 *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [41].

60 [1995] 2 SLR(R) 866.

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

is now; *ie*, they assume that the legislative reform suggested above does not materialise. Firstly, one could say that the *IA Approach* should not apply to working capital loans. The *IA Approach* is meant to help the court determine the nature of a loan, but arguably it is not an exclusive test for doing so. After all, it was originally put forward in *IA* as "a couple of rough guidelines";[61] the court in *BFC CA* described it as "the *IA* analytical framework".[62] Thus, there may be room to apply a different approach to working capital loans, under which they are recognised as revenue in nature. Borrowing costs incurred on them will then be deductible under s 14(1).[63]

55 The second approach is to determine the nature of a working capital loan by enquiring as to its use and not its purpose. Use and purpose are distinct.[64] An argument along the following lines may be advanced that the *Wharf* Principle is really calling for an enquiry as to the use of the loan moneys. When a company expends money that it did not obtain from a loan, an enquiry as to the purpose of the expenditure is in substance an enquiry as to the use of the moneys, because the purpose of expenditure is revealed directly and immediately in the very act of expending (*ie*, using) the moneys.

56 On the other hand, a loan in itself is not directly and immediately an expenditure of money; the loan moneys must first be used if there is to be expenditure, and such use could occur sometime after the loan moneys were first received. That said, the focus remains on use: it would be strange if a loan is capital in nature because its initial purpose was capital in nature, even if the loan moneys were subsequently used for a

61 *Comptroller of Income Tax v IA* [2006] 4 SLR(R) 161 at [66].

62 *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 at [32].

63 The "temporary and fluctuating test" that was subsumed under the *IA Approach* (see *Comptroller of Income Tax v IA* [2006] 4 SLR(R) 161 at [79]) should not be used to deal with the working capital loan conundrum. Working capital loans come in many forms, including by way of revolving credit facilities and short-term loans that are constantly renewed. It is uncertain in what way the myriad of different loan terms can be analysed to determine the nature of the loan. Indeed, it is best that the court in *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 did not refer to the "temporary and fluctuating test" at all when applying the *IA Approach* to the facts of the case, thus suggesting that the test is of very limited use.

64 See *BFC v Comptroller of Income Tax* [2013] 4 SLR 741 at [113]. In some cases, the distinction will be important. In *BFC v Comptroller of Income Tax*, the company contended that the 1996 bonds were used to finance its day-to-day operations, but the court looked at the company's Board Resolution and Information Memorandum and concluded that the purpose of the 1996 bonds was to refinance the existing borrowings of the company and its subsidiaries. Unfortunately, it is not very clear whether the company's contention failed because it did not sufficiently show that the 1996 bond proceeds were used to finance its day-to-day operations. See *BFC v Comptroller of Income Tax* [2013] 4 SLR 741 at [6], [87], [93] and the particularly confusing statements at [113]. The Court of Appeal accepted the High Court's finding without question.

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

revenue purpose; indeed, this focus on use is implied by the fact that the court recognises that the initial purpose of the loan may change.[65] Thus, we could say that, where the loan moneys have been used, the test is to look at the use of the loan moneys, rather than the loan's purpose.[66]

57 If the true enquiry is as to use of the loan moneys, working capital loans will be revenue in nature and their related borrowing costs deductible under s 14(1) since, by definition, the loan moneys are mainly applied to a variety of revenue purposes (*eg*, the payment of trade creditors or employees' salaries). Working capital loans are no longer capital in nature simply because in trying to determine their purpose, we fail to link them to any main transaction for which they were taken.

58 The third approach is to confine the "direct link" requirement in s 14(1)(*a*) to situations involving investment holding businesses only. The "direct link" requirement was formulated and applied in *Andermatt* and *JD* respectively. Both cases involved investment holding companies that held discrete identifiable share investments, meaning it was relatively simple to link dividend income from particular shares to the underlying loan moneys that were used to acquire those shares.[67] Perhaps those cases intended for the "direct link" requirement to apply only where the business is an investment holding one?[68]

---

65 *BFC v Comptroller of Income Tax* [2013] 4 SLR 741 at [79] and [80], referring to *Comptroller of Income Tax v IA* [2006] 4 SLR(R) 161 at [39] and [90]–[91]. We could say that in such a situation, the eventual use of the loan moneys is the amended purpose of the loan.

66 The caveat "where the loan moneys have been used" is important. The enquiry as to the use of the loan moneys presupposes that the moneys are used. If the loan moneys are kept as reserves and not used, then we can determine the nature of the loan by reference to its purpose. This is to allow the borrowing costs incurred when the loan moneys are kept as reserves to be considered for deduction. However, when the loan moneys are subsequently used, the nature of the loan should then be reassessed in the light of this use.

67 In *Andermatt Investments Pte Ltd v Comptroller of Income Tax* [1995] 2 SLR(R) 866, the court concluded that there was no "direct link" between the costs incurred on an overdraft used to pay the outstanding purchase price to a seller of shares in a private company, and rental income from a property at Hillview that was owned by that same private company. In *JD v Comptroller of Income Tax* [2006] 1 SLR(R) 484, the "direct link" requirement meant that it was necessary for interest expenses in relation to portions of borrowed funds to be linked to the dividend income earned from particular share counters that were purchased using the relevant portions of the borrowed funds.

68 Section 10E currently provides that where a company that is in the business of making investments incurs expenses in respect of investments that do not produce any income, these expenses are not deductible, thus making the "direct link" a statutory requirement for such companies. Section 10E did not exist when the "direct link" test was formulated in *Andermatt Investments Pte Ltd v Comptroller of Income Tax* [1995] 2 SLR(R) 866. This could support the view that the "direct link" requirement should only be applied where the deduction sought is in the context of the business of investment holding.

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.

59 If the "direct link" requirement only applies to investment holding businesses, the question arises for other businesses: under s 14(1)(*a*), what is the nature of the link required between the borrowing costs and the acquisition of income? Clearly, the wide approach of increased overall profitability under s 14(1) should not be adopted; if it is there will be no justification for the differences in wording between the two sections. Perhaps the correct approach lies somewhere in the middle. Hopefully, any new approach will allow borrowing costs on working capital loans to be deducted, without the unrealistic requirement that the loan moneys be directly linked to a capital asset that generates income.

VI. Conclusion

60 As a result of the Two Principles, the conundrum arises: how to prevent s 14(1)(*a*) from being otiose? Unfortunately, the Carve Out provided in *BFC CA* is unsatisfactory because it has no basis and leads to uncertainty regarding other deduction provisions, and should be discarded. There is no easy alternative solution to the conundrum. In fact, the *Wharf* Principle, which is at the core of our deductibility regime for borrowing costs, leads to confusion regarding the distinction between the deduction and capital allowance regimes in our ITA, and should also be discarded. Ultimately, the best solution to these issues is comprehensive legislative reform aimed at achieving pre-identified policy goals. Finally, there remains a second, lesser conundrum: can borrowing costs on working capital loans ever be deducted? This article has offered some potential approaches to resolving this second conundrum.

© 2015 Contributor(s) and Singapore Academy of Law.
No part of this document may be reproduced without permission from the copyright holders.