Insights on Recent Tax Controversies

April 2021

In brief

From November 2020 to April 2021, there have been three reported decisions by the High Court (HC) and Court of Appeal (CA) involving tax controversies with the Inland Revenue Authority of Singapore (IRAS). Two of these decisions by the HC involved disputes under the Income Tax Act (ITA). The first case pertained to the application of the general anti-avoidance provision in s 33 of the ITA, and the second case concerned the taxability of an employee's severance payment under s 10(2)(a) of the ITA.

The final case relates to a decision by the CA concerning the assessment of property tax, and the interpretation of the terms "article" and "machinery" under s 2(2) of the Property Tax Act (PTA). The CA also made some observations on the relevance of material such as unenacted legislative amendments and administrative guidance to statutory interpretation.

Contact Information

Allen Tan
Principal
Singapore

Dawn Quek
Principal
Singapore

Shih Hui Lee
Principal (Tax Advisor)
Singapore

Jaclyn Ho
Local Principal (Tax Advisor)
Singapore

Key takeaways

While these cases involve different areas of tax law, they serve as a reminder to taxpayers that the courts will not accept an interpretation of the relevant tax legislation which would stretch its meaning beyond what its language and context can reasonably bear. Taxpayers should also bear in mind that the determination of whether they come within the scope of the relevant tax legislation ultimately requires a factual analysis.

The application of the general anti-avoidance rule

In *Wee Teng Yau v Comptroller of Income Tax and another appeal* [2020] SGHC 236, the taxpayer was a dentist who was employed by an orthodontic clinic, ACOC. He subsequently incorporated a private limited company, SPL, of which he was the sole director and shareholder. On the same day that SPL was incorporated, the taxpayer left the employ of ACOC. The taxpayer, ACOC and SPL then entered into the following arrangement:

a) The taxpayer would continue to provide the same dental services to ACOC's patients, but ACOC would now pay for the taxpayer's services to SPL instead.
b) SPL would pay the taxpayer a reduced salary and a director's fee. Dividends (which are tax exempt under Singapore's one-tier corporate tax system) were also declared by SPL and paid to the taxpayer using the remaining profits in SPL.
c) During the material time, the only patients that the taxpayer had were ACOC's patients.

IRAS invoked the general anti-avoidance provision under s 33 of the ITA to re-characterise the transaction and treat the service income that was received by SPL as employment income derived by the taxpayer. The relevant provisions in the ITA are set out below for ease of reference.

Section 33(1)	Where the Comptroller is satisfied that the purpose or effect of any arrangement is directly or indirectly –

	(a) to alter the incidence of any tax which is payable by or which would otherwise have been payable by any person; (b) to relieve any person from any liability to pay tax or to make a return under this Act; or (c) to reduce or avoid any liability imposed or which would otherwise have been imposed on any person by this Act, the Comptroller may, without prejudice to such validity as it may have in any other respect or for any other purpose, disregard or vary the arrangement and make such adjustments as he considers appropriate, including the computation or recomputation of gains or profits, or the imposition of liability to tax, so as to counteract any tax advantage obtained or obtainable by that person from or under that arrangement.
Section 33(3)(b)	This section shall not apply to — … (b) any arrangement carried out for bona fide commercial reasons and had not as one of its main purposes the avoidance or reduction of tax.

A. Whether the arrangement fell within s 33(1) of the ITA

As a preliminary point, the HC took a different approach from that of the Income Tax Board of Review (ITBR) and held that there was in essence only one arrangement, albeit in two parts (i.e., the incorporation of SPL and the remuneration of the taxpayer).

The net result of the arrangement was that the taxpayer receives the same amount of pay from ACOC, but avoids the tax that he used to pay, since SPL could be used to extract tax benefits previously unobtainable by the taxpayer himself. As such, the court held that the taxpayer had derived a tax advantage pursuant to this arrangement, and that he fell within the alternative threshold limbs of s 33(1) (specifically, ss 33(1)(a) and (c)).

B. Whether the statutory exception in s 33(3)(b) of the ITA applied

The issue was then whether the taxpayer could rely upon the statutory exception under s 33(3)(b) of the ITA. Applying the principles set out in the CA case of *Comptroller of Income Tax v AQQ* [2014] 2 SLR 847, the HC noted that its task was to "inquire into the tax advantage the taxpayer hopes to obtain from the arrangement in question," and that the exemption under s 33(3)(b) would not apply "if the taxpayer's intentions, as inferred from the surrounding evidence or features of the arrangement, were to reduce or avoid tax liability". On the facts, the HC held that it was clear that the taxpayer's "main, if not only, purpose" was to avoid tax.

That said, the HC recognised that doctors can set up private limited companies for various purposes such as delegating the management of business or limiting the practitioner's liability, and these are not the arrangements contemplated under s 33 of the ITA.

C. Whether the personal exertion principle applied

The HC also addressed an argument advanced by the IRAS at the ITBR, that the taxpayer alternatively ought to be taxed for the full amount paid by ACOC to SPL on the basis of the common law "personal exertion" principle (i.e., that a person cannot avoid paying taxes for work done by him simply by assigning his pay to someone else). The HC rejected this argument, as the "personal exertion principle" is not a common law exception that allows the Comptroller to levy tax that the ITA has not provided for. In addition, it is fundamental that nothing would attract taxation unless the ITA provides for it. Finally, the principle was also irrelevant given that ss 33(1)(a) and (c) applied to the present arrangement.

D. Observations

Going forward, we expect that IRAS may continue to invoke s 33 against what it perceives to be tax avoidance arrangements, given its broad scope. Taxpayers should be mindful about the defensibility of their business arrangements and to take the necessary advice as part of their business planning, given the potential for such arrangements to be challenged in the future. In particular, the ability to invoke the defence under s 33(3)(b) is a reasonably high threshold to meet as the taxpayer must be able to demonstrate two conditions — first, that the arrangement was indeed for bona fide commercial reasons, and, second, that the arrangement had not as one of its main purposes the avoidance or reduction of tax. It would not be sufficient for the taxpayer to make a mere assertion of its subjective intentions, as the facts and evidence must be assessed objectively in the round.

Taxpayers should also note that under s 33A of the ITA, with effect from the Year of Assessment 2023, a surcharge will be imposed on taxpayers if the Comptroller makes an adjustment under s 33 of the ITA. The surcharge will be equal to 50% of the amount of tax or the additional amount of tax imposed. Given these developments, it is even more important for taxpayers to be aware of the potential risks of their business arrangements being potentially challenged by the IRAS under s 33 of the ITA.

The taxation of severance payments

The HC in *Comptroller of Income Tax v Forsyth, John Russell* [2020] SGHC 258 considered the taxability of a severance payment made to the taxpayer upon the termination of his employment. Clause 9 of the taxpayer's Employment Agreement provided that in the event of a termination of employment initiated by the company, the company will make an ex gratia payment to the taxpayer in accordance with a pre-determined formula in consideration for the taxpayer executing a deed of release. Clause 15 of the Employment Agreement provided that either party can terminate the employment by giving notice.

The taxpayer was sacked from his post without warning. Upon termination, there was no deed of release executed under Clause 9 of the Employment Agreement. Instead, the company entered into a new Separation Agreement with the taxpayer, which had the effect of extinguishing the taxpayer's rights under the Employment Agreement, in consideration for a severance payment totaling S$2,475,000 (payable in two instalments — one on 31 December 2016, and one on 31 July 2017). Clause 3 of the Separation Agreement provided that severance payments include any and all entitlements which may have been due to the taxpayer under Clauses 9 and 15 of the Employment Agreement.

IRAS assessed S$1,350,000 of the severance payment to tax. The IRAS took the view that it was an ex gratia payment paid pursuant to Clause 9 of the Employment Agreement. The taxpayer disagreed with IRAS' assessment of the amount of S$1,350,000 to tax and argued that this payment was for the loss of office and therefore not taxable. The HC agreed with the taxpayer and held that the full sum of S$2,475,000 was compensation for his loss of employment and not taxable under s 10(2)(a) of the ITA. The relevant provisions in the ITA are set out below for ease of reference.

Section 10(1)	Income tax shall, subject to the provisions of this Act, be payable at the rate or rates specified hereinafter for each year of assessment upon the income of any person accruing in or derived from Singapore or received in Singapore from outside Singapore in respect of — … (b) gains or profits from any employment; …
Section 10(2)	In subsection (1)(*b*), "gains or profits from any employment" means — (a) any wages, salary, leave pay, fee, commission, bonus, gratuity, perquisite or allowance (other than a subsistence, travelling, conveyance or entertainment allowance which is proved to the satisfaction of the Comptroller to have been expended for purposes other than those in respect of which no deduction is allowed under section 15) paid or granted in respect of the employment whether in money or otherwise; …

A. How the sum of S$1,350,000 was derived

In arriving at its decision, the HC first clarified that the sum of S$1,350,000 was derived by the IRAS based on the fact that the taxpayer had been terminated after the first year of his employment. Thus, under Clause 9 of the Employment Agreement, he would be entitled to 12 months' base salary of S$675,000 and the full sum of his annual bonus of S$675,000. These added up to S$1,350,000.

B. Whether the sum of S$1,350,000 is taxable under s 10(2)(a) ITA

Having determined how the sum of S$1,350,000 was arrived at, the HC then considered whether this sum is taxable under s 10(2)(a) of the ITA. The HC held that this must be determined based on the strict wording of the taxing statute. In this regard, s 10(2)(a) contained an exhaustive definition of taxable gains or profits from employment and did not include redundancy payments or compensation for loss of employment.

After a detailed analysis of the relevant clauses in the Employment Agreement and Separation Agreement, the HC held that the sum of S$2,475,000 was compensation for the loss of the taxpayer's employment and thus not taxable. This was because:

a) The taxpayer was sacked without notice, and not under Clause 15 of the Employment Agreement.

b) Clause 3 of the Separation Agreement merely stated that the severance payment includes any and all entitlements which may have been due to the taxpayer under Clauses 9 and 15 of the Employment Agreement, and does not confirm that such entitlements were due. Thus, Clause 9 of the Employment Agreement was never triggered.

c) The severance payment was distinct from the ex gratia payment under the Employment Agreement. The ex gratia payment under Clause 9 of the Employment Agreement was expressed as a sum that was immediately due and payable, while the severance payment was expressed as a conditional sum which was subject to clawbacks by the company if the taxpayer breached his obligations under the Separation Agreement.

d) There was no evidence that the company had used the taxpayer's salary and bonus in calculating the severance payment. Even if they did, the only taxable income would be the income which the taxpayer had earned up to the day that he was sacked.

C. Whether the severance payment could be bifurcated

The HC disagreed with the ITBR that the sum of S$2,475,000 could be bifurcated, with the ex gratia payment under Clause 9 of the Employment Agreement forming a component of the severance payment. While the severance payment may be bifurcated if it expressly included payment of income which was taxable, Clause 9 of the Employment Agreement was never triggered on the facts. Thus, the ex gratia payment under Clause 9 could not have formed a part of the severance payment. In fact, the severance payment was to be paid in two instalments because the company wanted to withhold an amount to ensure that no misconduct on the taxpayer's part was discovered prior to the deadline of 31 July 2017.

D. Observations

In light of this decision, it is important for taxpayers to take note of the type of payments that fall within the ambit of s 10(2)(a) of the ITA as this is a prescriptive list of taxable types of employment income. Taxpayers who may receive severance payments in a similar scenario should also understand how the relevant agreements and contractual provisions are drafted, as this would have a significant impact in determining the nature of the payments received by the taxpayer and whether such payments are assessable to tax.

The definition of "machinery" under s 2(2) of the Property Tax Act

The taxpayer company is the owner and operator of a tourist attraction which provides a simulated skydiving experience for its guests (Property). The dispute concerned whether a "Wind Tunnel" (which was part of the Property) constituted "machinery" under s 2(2) of the PTA. If the Wind Tunnel satisfied s 2(2), its value would not be included in the assessment of the Property's annual value for the purposes of determining the amount of property tax chargeable.

S 2(2) of the PTA is set out below for ease of reference:

Section 2(2)	In assessing the annual value of any premises in or upon which there is any machinery used for any of the following purposes: (a) the making of any article or part thereof; (b) the altering, repairing, ornamenting or finishing of any article; or (c) the adapting for sale of any article, the enhanced value given to the premises by the presence of such machinery shall not be taken into consideration, and for this purpose "machinery" includes the steam engines, boilers and other motive power belonging to that machinery.

The CA held that the Wind Tunnel was not qualifying machinery under s 2(2) of the PTA. In its decision, the CA considered three issues:

a) the scope of s 2(2) of the PTA;

b) whether the Wind Tunnel is machinery; and

c) whether s 2(2) of the PTA applies to the Wind Tunnel, such that its value ought to be excluded from the Annual Value of the Property.

A. The scope of s 2(2) of the PTA

Based on the express language of s 2(2) of the PTA, the CA observed that s 2(2) would only apply where machinery was used for the purposes of making, altering, repairing, ornamenting or finishing or adapting for sale any "article". As "article" was not defined in the PTA, the CA had to interpret the term and held that "article" referred to a matter which is intended to be sold, or which is the subject matter of a sale of services to make, alter, ornament, finish or adapt the sale for the same.

In reaching its decision, the CA adopted a purposive approach to statutory interpretation by applying the framework laid out by the previous CA decision of *Tan Cheng Bock v Attorney-General* [2017] 2 SLR 850:

a) First, the court will ascertain the possible interpretations of the provision, having regard not just to the text of the provision but also the context of that provision within the written law as a whole.

b) Second, the court will ascertain the legislative purpose or object of the statutory provision in question.

c) Third, the court will compare the possible interpretations of the text against the purposes or objects of the statute. The interpretation which furthers the purpose of the written text should be preferred to the interpretation which does not.

Applying Step 1, the CA found that the word "article," at its broadest, may refer to any matter or thing whether occurring in nature or otherwise. However, the CA cautioned that whether such a generous interpretation would be warranted would depend on the particular statutory context in which the term is used (in this case, s 2(2) of the PTA) and in particular, the legislative intention underlying the relevant statutory provision.

Under Step 2, the CA referred to the earlier CA decision of *Chief Assessor and another v First DCS Pte Ltd* [2008] 2 SLR(R) 724 (First DCS), which observed (among others) that the language used in s 2(2) of the PTA was imported from earlier English legislation where such terms were used to define a "manufacturing process". Having imported such language into s 2(2) of the PTA, this indicated to the CA that Parliament had likely intended s 2(2) to incentivise the use of machinery for "manufacturing processes" and it was concluded by the CA that s 2(2) was to be interpreted in the context of a "manufacturing process".

Before turning to Step 3, the CA also addressed (and refused) the taxpayer's application for leave to tender certain materials to the court for purposes of interpreting s 2(2). The CA's refusal was premised on (amongst other reasons) the fact that the materials were irrelevant to the interpretation exercise as the materials comprised: (i) non-legislative articles relating to the state of Singapore's economy around 1960 and academic opinions on how that economy ought to be developed; (ii) materials relating to proposed and unenacted amendments to the PTA; and (iii) materials relating to the respondents' interpretation of s 2(2) after the enactment of s 2(2).

At Step 3, the CA pointed out that "article" under s 2(2)(c) of the PTA referred to something intended to be sold. Applying the presumption that Parliament intended a consistent definition of "article" throughout s 2(2) and noting that the legislative purpose of s 2(2) was to incentivise machinery used for manufacturing processes, the CA held that "article" bore the same meaning within the various sub-sections of s 2(2). As such, "article" referred to a matter which is intended to be sold or which is the subject matter of a sale of services to make, alter, repair, ornament, finish or adapt for sale the same.

B. Whether the Wind Tunnel is machinery

Having considered the scope of s 2(2) of the PTA, the CA then considered whether the Wind Tunnel was "machinery". Applying the "dominant function" test laid out in *Pan-United Marine Ltd v Chief Assessor* [2008] 3 SLR(R) 569, the CA considered whether the dominant function of the Wind Tunnel was one that would normally be attributed to machinery generally or if the Wind Tunnel was serving the dominant function of being the setting or environment in which the relevant work could take place. As the Wind Tunnel was found to constitute part of a system which creates, modifies and controls airflow, it was determined by the CA to be "machinery".

C. Whether the Wind Tunnel is qualifying machinery under s 2(2) of the PTA

As the taxpayer had conceded that the Wind Tunnel was not qualifying machinery under s 2(2)(a) of the PTA, the CA thus examined whether the Wind Tunnel constituted qualifying machinery under s 2(2)(c) and (b) of the PTA.

While the taxpayer argued that s 2(2)(c) was satisfied as it had adapted an article (i.e., the air) for sale, and analogised the present case to *First DCS*, this was rejected by the CA on the basis that the facts of *First DCS* could be distinguished. In *First DCS*, the taxpayer's machinery chilled water and circulated it to neighbouring buildings through underground pipelines. Water would then be returned to the taxpayer for re-chilling. The CA in *First DCS* held that the chilling effect of the water was sold, and the taxpayer's machinery had thus adapted an article for sale under s 2(2)(c) of the PTA. In the present case, the CA observed that there was no sale by the Taxpayer (unlike in *First DCS*, where property in the cooling or chilling effect of the water would pass completely from the taxpayer in return for monetary consideration from its customers). Airflow carrying skydiving-friendly aerodynamic properties entered the flight chamber, and airflow carrying the same aerodynamic properties exited the flight chamber to be recirculated afresh. Thus, there was no transfer of property (i.e., the skydiving-friendly aerodynamic properties of the air) to the customers of the taxpayer. Hence, the Wind Tunnel was not qualifying machinery under s 2(2)(c) of the PTA.

Similarly, the CA held that the Wind Tunnel was not qualifying machinery under s 2(2)(b) of the PTA. Although the Wind Tunnel altered airflow to induce its skydiving-friendly aerodynamic properties, such altered airflow was not an article which was intended to be sold per se. Additionally, there was no sale of an alteration service to the skydivers. The altered airflow existed at all material times in the taxpayer's premises, and the skydivers were charged a fee for the enjoyment of the altered airflow.

D. Observations

This decision clarifies the scope of s 2(2) of the PTA and has important implications for taxpayers in determining the annual value of their property, particularly for businesses which require the operation of machinery (in the general sense). Ultimately, determining whether the item is qualifying machinery under s 2(2) of the PTA requires a factual analysis and taxpayers should note, in particular, the definitions of "article" and "machinery" under s 2(2) of the PTA in light of this decision. The decision also affirms the court's circumspect approach where extraneous material is sought to be relied upon to interpret the law. When undertaking tax planning, taxpayers should bear in mind that interpretations from an administrative agency or non-legislative articles/opinions will not aid in an interpretation exercise carried out by the courts.

Concluding remarks

From these decisions, taxpayers will have to be increasingly well-versed with the relevant tax legislation, since this is of primary importance should the tax issue be presented before the courts. Taxpayers should also be aware of the approach taken by the courts in interpreting the relevant tax legislation, which will cut across all areas of tax law. In the context of tax planning, taxpayers should be mindful of the defensibility of their business arrangements and to take the necessary advice as part of their planning, given the potential for such arrangements to be challenged in the future. The determination of whether taxpayers fall within the ambit of s 33 of the ITA is crucial given the imposition of surcharges on adjustments under s 33 of the ITA that will apply in the near future.