BML *v* Comptroller of Income Tax
[2018] SGCA 53

Case Number	: Civil Appeal No 119 of 2017
Decision Date	: 29 August 2018
Tribunal/Court	: Court of Appeal
Coram	: Sundaresh Menon CJ; Tay Yong Kwang JA; Steven Chong JA
Counsel Name(s)	: Ong Sim Ho, Keith Brendan Lam Xun-Yu and Khoo Puay Pin Joanne (Ong Sim Ho) for the appellant; Foo Hui Min Felicia, Lim Chun Heng Christopher and Lim Weng Kee David (Inland Revenue Authority of Singapore (Law Division)) for the respondent.
Parties	: BML — Comptroller of Income Tax

Revenue Law – Income taxation – Deduction

[LawNet Editorial Note: This was an appeal from the decision of the High Court in [2017] SGHC 118.]

29 August 2018 Judgment reserved.

Tay Yong Kwang JA (delivering the judgment of the court):

Introduction

1 This appeal deals with the issue of the deductibility of interest paid on bonds issued by a taxpayer to its shareholders in the course of a capital restructuring exercise. The appellant ("the Taxpayer") is a company which owns and operates a mall in the western region of Singapore ("the Mall"). The Taxpayer's two shareholder companies ("the Shareholders") own 50% each of the issued share capital of the Taxpayer. In 2004, the Taxpayer conducted a securitisation exercise ("the Securitisation Exercise") followed by a capital restructuring exercise which was effected in two steps: (a) a capital reduction exercise ("the Capital Reduction Exercise") followed by (b) a bond issue to the Shareholders ("the Shareholder Bonds"). This capital restructuring exercise in effect converted the Shareholders' equity in the Taxpayer into a debt investment.

2 The issue before us is whether the Shareholder Bonds constitute "capital employed in acquiring the income" of the Taxpayer such that the interest paid on them is deductible under s 14(1)(*a*) of the Income Tax Act (Cap 134, 2014 Rev Ed) ("ITA"). The Taxpayer argues that the interest expense was deductible because the Shareholder Bonds enabled the Taxpayer to retain the Mall and were represented by the Taxpayer's income-producing assets. The Comptroller of Income Tax ("the CIT") disallowed the deduction on the basis that the Taxpayer failed to show a direct link between the Shareholder Bonds and the acquisition of the income against which the deductions were sought.

The background facts

The Securitisation Exercise

3 On 17 September 2004, [WM] Limited ("WM") was incorporated by the Taxpayer as a special purpose vehicle. Following from this, a number of transactions took place involving WM, its two Shareholders and the Taxpayer. We attach in the Annexures to this judgment two diagrams tendered

by the CIT to the Income Tax Board of Review ("ITBR") to aid in the understanding of the said transactions and the flow of funds resulting from them.

4 On 27 October 2004, WM raised $520m by a bond issue. Of the $520m raised, the Shareholders subscribed to $205m of subordinated junior bonds. [note: 1] The Shareholders considered it crucial for them to subscribe to these junior bonds because, first, it would have been "practically impossible" to find third party investors willing to subscribe to these bonds at the interest rate of 4.05%, and second, the Shareholders' subscription would signal confidence in the Mall's performance to other potential investors. [note: 2]

5 Subsequently, WM lent the $520m raised from the bond issue to the Taxpayer under a facility agreement ("the WM Loan") at an effective interest rate of 3.728% per annum. [note: 3] The WM Loan was made in consideration of periodic interest payable by the Taxpayer to WM and was secured by, among other things: [note: 4]

(a) a fixed charge over a set of accounts to be opened and maintained by the Taxpayer, and

(b) an assignment of the Taxpayer's rights over the tenancy agreements and rental income from the Mall.

6 The amount of the WM Loan, *ie*, $520m, was in line with the full market value of the Mall, which was valued in 2004 at $525m. [note: 5] According to the Taxpayer, it chose to assign its rights to the rental income from the Mall as security for the WM Loan so that it could continue to own and operate the Mall, which was at that time its only income-earning asset. [note: 6]

7 The Taxpayer applied the $520m obtained from the WM Loan in the following manner:

(a) $170m was used to refinance pre-existing borrowings;

(b) $17m was used as working capital; and

(c) $333m was lent to the Shareholders pursuant to loan agreements dated 20 October 2004, under which $166.5m was advanced to each Shareholder on an unsecured basis at an interest rate of 3.78% per annum ("the Shareholder Advances"). [note: 7] The stated purpose of the Shareholder Advances was to enable the Shareholders to subscribe to the subordinated junior bonds issued by WM [note: 8] and to allow their use as general working capital. [note: 9]

8 Following the Securitisation Exercise, the Taxpayer's primary income-generating assets were (a) the interest income from the Shareholder Advances [note: 10] and (b) the rental income from the Mall. For the financial years ending 31 December 2004 through to 2008, the Taxpayer's total assets ranged between approximately $889m and $996m. During this period, the Mall was valued at between $525m and $614m while the Shareholder Advances remained at a consistent $333m. [note: 11]

9 At the same time, the Taxpayer had to pay WM interest on the WM Loan. CIT allowed the Taxpayer to deduct the full amount of interest expense incurred on the WM Loan under s 14(1)(*a*) of the ITA. [note: 12]

The capital restructuring exercise

10 Following the Securitisation Exercise, the Taxpayer engaged in a two-step restructuring of its capital structure, involving first the Capital Reduction Exercise and thereafter the issuance of the Shareholder Bonds.

11 Prior to 26 November 2004, the Taxpayer had a paid-up share capital of $10.2m. [note: 13] On 26 November 2004, at an extraordinary general meeting of the Taxpayer, the Shareholders resolved to reduce the share capital of the Taxpayer by the following steps: [note: 14]

(a) capitalise a sum of $325.3m (comprising $37m from retained earnings, $268.3m from the asset revaluation reserve and $20m from the capital redemption reserve); and thereafter,

(b) reduce its share capital by $333m (from $335.5m to $2.5m) by a return of the sum to the Shareholders in proportion to their shareholding.

12 On 2 December 2004, the Capital Reduction Exercise was approved by the High Court. [note: 15] This brought about two consequences: (a) the Taxpayer was left with a paid-up share capital of only $2.5m and (b) a debt of $333m became immediately due and payable by the Taxpayer to the Shareholders.

13 On 15 December 2004, [note: 16] in place of the debt of $333m immediately due to the Shareholders, [note: 17] the Taxpayer decided to issue the Shareholder Bonds, which were fixed rate subordinated bonds for an aggregate amount of $333m. The Shareholder Bonds carried interest of 7.1% per annum and would mature in 2011. Each of the Shareholders subscribed to 50% of the issue. [note: 18] The Shareholder Bonds thus formed part of the Taxpayer's capital [note: 19] and they apparently allowed the Taxpayer to meet its capital needs after the Capital Reduction Exercise. [note: 20] According to the affidavit of a director of the Taxpayer: [note: 21]

> 11 The decision to issue the Shareholder Bonds was necessary to complete the restructuring of the Shareholder's holding in the [Taxpayer] from equity to debt without any disruption of the [Taxpayer's] ownership of and its business of operating the Mall. …
>
> 12 The issuance of the Shareholder Bonds was a practical financing option, absent of which, the [Taxpayer] would have been unable to satisfy its obligations arising as a result of the Capital Reduction Exercise without a sale of the Mall, which was the Company's only income producing asset, or obtaining alternative finance. Neither of these alternative courses were considered. First, it was the intention of the [Taxpayer] to continue its business of owning and operating the Mall. Second, obtaining new financing from third party banks would likely be too costly as a result of the early securitisation exercise.

14 Further, the Shareholder Bonds apparently provided comfort to the Taxpayer as there would be no danger of the Shareholders calling on the debt so long as interest on the bond was paid in a timely manner.

15 Collectively, the Capital Reduction Exercise and the issuance of the Shareholder Bonds gave effect to an equity-to-debt restructuring of the Taxpayer's capital by replacing the Shareholders' equity in the company with debt in the Shareholder Bonds. [note: 22] This capital restructuring exercise was said to serve two purposes:

(a) First, it allowed the Shareholders to earn interest rather than dividends. Unlike dividends,

interest payments are independent of the Taxpayer's ability to service the WM Loan. [note: 23] This restructuring therefore addressed the anticipated problem that the Taxpayer's ability to pay dividends would be heavily curtailed after the Securitisation Exercise. Further, interest payments also allowed the Shareholders' return on investment to be exempted from capital maintenance rules imposed by the Companies Act (Cap 19, 2008 Rev Ed). [note: 24]

(b) Second, it was said that the restructuring of the Shareholders' investment was "timely" given the transition from an imputation system to a one-tier system of taxing corporate profits. [note: 25]

The contested Notices of Assessment

16 Between 2005 and 2009, the Taxpayer paid interest of 7.1% per annum to the Shareholders on the Shareholder Bonds ("the Interest Expense").

17 The deductibility of the Interest Expense under s 14(1)(*a*) of the ITA is the subject of contention here and below. The Taxpayer sought to deduct it from its chargeable income in the Years of Assessment ("YAs") 2005 to 2009. The CIT disallowed the deductions and issued Notices of Refusal to Amend in respect of each of the Taxpayer's objections against the five assessments for YAs 2005 to 2009. [note: 26]

18 The contested interest expense in each YA is tabulated as follows: [note: 27]

Year of assessment	Interest Expense in contention (S$)
2005	1,101,181
2006	23,643,000
2007	23,643,000
2008	23,643,000
2009	23,643,000
Total	95,673,181

The decision below

Income Tax Board of Review

19 On 21 November 2013, the Taxpayer filed five Notices of Appeals to the ITBR against the CIT's decision to disallow the deduction of the Interest Expense. [note: 28]

20 On 8 November 2016, the ITBR issued its decision affirming the CIT's decision ("the ITBR Judgment").

21 The ITBR started with the legal premise established by this Court in *BFC v Comptroller of Income Tax* [2014] 4 SLR 33 ("*BFC*") that the Interest Expense would be deductible even if it was capital expenditure falling within s 15(1)(*c*) of the ITA so long as it satisfied s 14(1)(*a*). On this premise, the ITBR found that the Interest Expense was not deductible for the following reasons:

(a) There was no direct link between the incurring of the Interest Expense and the rental income from the Mall. The securitisation and capital reduction had no impact on the generation of rental income, which covered the operating expenses of the Mall. The Shareholder Bonds were not needed to preserve the Mall as there was no reason to think that the Shareholders would compel the Taxpayer to sell the Mall to satisfy the debt following the Capital Reduction Exercise. See ITBR Judgment at [26] and [28].

(b) The case of *Zeta Estates Ltd v Commissioner of Inland Revenue* [2007] HKLRD 102 ("*Zeta Estates*"), relied upon by the Taxpayer in support of a "balance sheet test" instead of the direct link test, was to be treated with caution as the relevant section of the Hong Kong Inland Revenue Ordinance (Cap 112) (HK) ("HK IRO") was "more liberal" than s 14(1)(*a*) of Singapore's ITA. Further, the facts of *Zeta Estates* were materially distinguishable. See ITBR Judgment at [31]–[34].

(c) Third, the Shareholder Bonds were not substituted financing. The ITBR construed "substituted financing" narrowly to refer only to debt refinancing and not equity-to-debt restructuring. Since the Shareholder Bonds did not replace any loan, the cases on "substituted financing" did not assist the Taxpayer. See ITBR Judgment at [35]–[36].

22 The ITBR was "unmoved" by the commercial justifications underpinning the capital restructuring. These justifications and considerations did not justify tax deductibility. See ITBR Judgment at [38].

High Court

23 On 29 November 2016, the Taxpayer appealed to the High Court against the whole of the ITBR Judgment. [note: 29] On 5 June 2017, the High Court judge ("the Judge") dismissed the Taxpayer's appeal in *BML v Comptroller of Income Tax* [2017] SGHC 118 ("the HC Judgment").

24 Applying the Court of Appeal's decision in *BFC*, the Judge's starting legal premise was that s 14(1)(*a*) of the ITA was an exception to the prohibition against deduction of capital expenditure in s 15(1)(*c*) of the ITA. Thus, the issue it had to consider was whether the Interest Expense fell within the scope of s 14(1)(*a*) (at [7]). In this regard, the Judge affirmed the applicability of the direct link test (at [19]). The Judge also rejected the Taxpayer's submission that "so long as the money borrowed is to obtain capital that is represented by income-producing assets, the interest payable on such money borrowed would be on capital employed in acquiring the income from these assets" (at [11]).

25 The Judge then examined three factors which the Taxpayer alleged that the CIT should not have had regard to, bearing in mind that the court should be slow to interfere with the CIT's discretion because the ITA conferred on the CIT "a wide discretion in deciding which and to what extent those factors are relevant" (at [20]):

(a) First, whether the money borrowed had an observable effect on the income against which deduction was sought is a relevant factor (at [22]). If the only perceptible change caused by a transaction is to the capital structure of the company, with no ostensible effect on income and no acquisition of assets, the money borrowed may not be directly linked to the income-earning operations (at [23]). That link was not present in this case as a large part of the $333m payable to the Shareholders after the Capital Reduction Exercise had been capitalized from the company's asset revaluation reserve (at [27]).

(b) Second, the purpose for which money was borrowed is relevant. It does not in itself prove

a direct link, or sever the link, but it is "relevant in some cases to show how the capital had been used, especially when the statute itself implies a purpose such as the acquisition of income." (at [30]). It may be that where there are two purposes for which money is borrowed, one to produce income and the other to obtain a capital advantage, then even if the latter is the dominant purpose, it should not automatically sever the direct link between the money borrowed and income produced (at [31]). However, this was not such a case as the Taxpayer had from the outset intended to conduct an equity-to-debt restructuring (at [32]).

(c) Third, the necessity of the borrowing in order to preserve income-earning assets is relevant (at [33]). Here, the Shareholder Bonds were needed to replace the missing capital following the Capital Reduction Exercise (at [35]). However, "something more is needed beyond the loan simply being necessary for the taxpayer to avoid selling its assets" and that, the Taxpayer failed to show (at [37]).

26 The Judge observed in conclusion that the court would not intervene without proof that the CIT had taken into account irrelevant considerations that were material to its findings or had arrived at an objectively unreasonable result. Here, the CIT's decision and the ITBR's affirmation of it were neither unreasonable nor wrong. The CIT correctly considered the factors in denying deduction of the Interest Expense on the Shareholder Bonds from the Mall's rental income (at [40]).

The arguments on appeal

27 The Taxpayer filed a Notice of Appeal to this Court against the whole of the HC Judgment on 28 July 2017. [note: 30]

28 In the present appeal, the Taxpayer submitted that the Interest Expense should be deductible under s 14(1)(*a*) of the ITA because the Shareholder Loans enabled it to retain the Mall and were represented by the Taxpayer's income-producing assets which were the Mall and the Shareholder Advances. The following key arguments, among others, were made:

(a) The Judge construed s 14(1)(*a*) wrongly. The direct link test is not the exclusive test under s 14(1)(*a*). In any event, insofar as the Judge read the requirement of causation into the direct link test, that is inconsistent with case law and the statutory scheme of the ITA.

(b) Capital is "employed in acquiring the income" within the meaning of s 14(1)(*a*) where income-producing assets are retained or are represented by the said capital. On the facts, the Shareholder Bonds enabled the Taxpayer to retain the Mall and the Shareholder Advances. [note: 31] These assets produced taxable income for the Taxpayer throughout the relevant periods. [note: 32] The Interest Expense should therefore be deductible.

(c) The Interest Expense should be deductible under s 14(1)(*a*) as the present facts are analogous to three cases in which deductions were either allowed or were opined to be allowable.

(d) The CIT does not have a wide discretion under s 14(1)(*a*) to consider all manner of factors in determining deductibility. [note: 33]

29 The CIT's main argument was that the direct link test applied and that the test was not satisfied in respect of the Shareholder Bonds. The Interest Expense should therefore not be deductible. The following key submissions were made:

(a) The direct link test is the universal test for s 14(1)(*a*). It is supported by case authorities [note: 34] and is easily understood. [note: 35]

(b) The test of representation urged by the Taxpayer should be rejected as it is based on a "strained and narrow reading of *Andermatt* and unwarranted extrapolations of foreign case authorities". [note: 36]

(c) On the facts, the Shareholder Bonds were not directly linked to the acquisition of rental income from the Mall. [note: 37] This was because such rental income "was not acquired or retained in consequence of the interest on Shareholder Bonds". [note: 38]

(d) Other factors also showed that the direct link test is not satisfied. For instance, the Shareholder Bonds had no tangible or perceptive effect on the Taxpayer's income or assets. [note: 39] They also did not cause the acquisition of rental income. [note: 40]

(e) Under s 14(1)(*a*), the CIT has a discretion in determining if the interest expense is directly linked to the income from which deduction is sought and the court should not intervene unless the exercise of discretion is "unreasonable in a *Wednesbury* sense". [note: 41]

The analysis

Statutory context of s 14(1)(a)

30 Generally, since income tax is levied in respect of only revenue receipts and not capital receipts, as a corollary, deductions are also allowed only in respect of revenue expenditure and not capital expenditure. The revenue-capital distinction is fundamental to the law of income taxation and it "is not infrequently a matter of considerable difficulty" (*BFC* at [15]). In *BFC*, this Court provided an "adequate working formulation" of the distinction in the context of expenditures in the following terms (at [12]):

> The distinction between capital expenditure and revenue expenditure is that between 'the cost of creating, acquiring or enlarging the permanent (which does not mean perpetual) structure of which the income is to be the produce or fruit' on the one hand, and 'the cost of earning that income itself or performing the income-earning operations' on the other.

31 A "composite and integrated approach" to characterizing an item of expenditure as capital or revenue in nature was also laid down by Andrew Phang Boon Leong JA sitting in the High Court in *ABD Pte Ltd v Comptroller of Income Tax* [2010] 3 SLR 609 ("*ABD*") at [71]–[75].

32 The general rule that only revenue expenditure is deductible is enshrined in and abridged by Part V of the ITA, which is entitled "Deductions against income". There are two main provisions in this part: (a) s 14 provides a general deduction formula and a specific list of deductible expenditures and (b) s 15 provides a list of non-deductible expenditures. In between, ss 14A to 14ZB of the ITA provide for special and further deductions in relation to specific types of expenditures (see Pok Soy Yoong, Ng Keat Seng & Steven M Timms, *The Law and Practice of Singapore Income Tax* (LexisNexis, 2nd Ed, 2013) ("*Singapore Income Tax*") at para 8.241).

33 The relevant provision in issue here is s 14(1)(*a*) of the ITA, which reads as follows:

Deductions allowed

14.—(1) For the purpose of ascertaining the income of any person for any period from any source chargeable with tax under this Act (referred to in this Part as the income), there shall be deducted all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of the income, including —

(*a*) except as 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;

[…]

34 Prior to 2007, a different version of s 14(1)(*a*) of the ITA was in operation but nothing in this dispute turns on the amendment which was introduced by the Income Tax (Amendment No 2) Act (Act 53 of 2007).

35 Section 15 of the ITA sets out a list of the types of expenditure that cannot be deducted in law. In particular, s 15(1)(*c*) provides for the general rule prohibiting the deduction of capital expenditures:

Deductions not allowed

15.—(1) 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*);

…

36 Section 14(1)(*h*) of the ITA concerns the working of a mine or other source of mineral deposits and is of no relevance here.

37 The interaction between ss 14(1), 14(1)(*a*) and 15(1)(*c*) is an important but perplexing issue. The High Court and this Court have discussed this issue in several decisions including *T Ltd v Comptroller of Income Tax* [2005] 4 SLR(R) 285 (which was the High Court decision) and *T Ltd v Comptroller of Income Tax* [2006] 2 SLR(R) 618 (which was the Court of Appeal decision). Based on this Court's decision in *BFC* at [37]–[42], the current position is that capital expenditure is generally not deductible under s 15(1)(*c*) of the ITA. This is so even if the general deduction formula under s 14(1) is satisfied, since s 14(1) is not an exception to s 15(1)(*c*). However, since s 14(1)(*a*) *is* an

exception to s 15(1)(*c*), an interest expense will be deductible so long as s 14(1)(*a*) is satisfied even if it is capital in nature. We appreciate that there has been some concern with the approach taken in *BFC*. However, the difficulties with the proper interaction of s 14(1)(*a*) and the other provisions do not arise in this case, which concerns primarily the scope and factual application of s 14(1)(*a*) of the ITA. In any event, neither party saw the need to challenge any of the principles in *BFC*. Therefore, we will proceed on the basis of the principles in *BFC* for present purposes.

The direct link test

38 Under s 14(1)(*a*) of the ITA, interest paid on a loan is deductible in the assessment of one's chargeable income if, among other things, the CIT is satisfied that the loan constitutes "capital employed in acquiring the income". The first issue is therefore what approach governs the analysis of this phrase, "capital employed in acquiring the income".

Genesis of the test

39 Traditionally, this phrase is taken to imply a direct link requirement. The genesis of this direct link test is the Court of Appeal's decision in *Andermatt Investments Pte Ltd v Comptroller of Income Tax* [1995] 2 SLR(R) 866 ("*Andermatt*") where the court held that the phrase "capital employed in acquiring the income" in s 14(1)(*a*) required a direct link between the money borrowed and the income produced. In that case, the taxpayer company desired to purchase a property owned by another company. In order to take advantage of a tax concession in the applicable Stamp Duties Act (Cap 312, 1985 Rev Ed), the taxpayer decided to acquire the property indirectly by purchasing the latter company's shares and thereafter initiating its voluntary winding up, rather than purchasing the property directly. The shares of the target company were accordingly acquired by the taxpayer on 8 December 1987. Two months later, on 8 February 1988, the taxpayer obtained an overdraft facility to finance the remaining consideration for the prior acquisition of the company. On 31 March 1988, the property was transferred to the taxpayer pursuant to the voluntary liquidation of the target company. The issue was whether the taxpayer was entitled to deduct the interest paid on the overdraft facility against the rental income derived from the transferred property.

40 The Court of Appeal affirmed the direct link test in the context of s 14(1)(*a*) and held, on the facts, that the test was not satisfied as the overdraft had been taken out for the purpose of acquiring the shares of the target company rather than the property itself which generated the rental income:

> 26 Reverting to the problem in hand, it seems to us that at the end of the day it is the few key words in the section which are going to decide the matter: "capital employed in acquiring the income". It is only when the answer to this question, whether the overdraft was employed in acquiring the rental income, is in the affirmative that the interest incurred would be deductible from the rental income. We do not think one should disregard the manner in which the appellant has gone about arranging the transaction. Whatever may be said to be the motive behind the arrangement, there is no denying that the overdraft was used to pay a debt, or the purchase price of the shares from the vendors. … The overdraft has nothing to do with the acquisition of the … property, except in the remote sense.
>
> 27 We endorse the view that under s 14(1)(*a*) there must be a direct link between the money borrowed and the income produced. …

41 The direct link test was next discussed by the Court of Appeal in *JD Ltd v Comptroller of Income Tax* [2006] 1 SLR(R) 484 ("*JD (CA)*"). In that case, the taxpayer was an investment holding

company that received dividend income from long term equity investments in other companies. Some of these investments did not produce dividend income while others produced dividend income for only certain YAs. These investments were financed in part by interest-bearing loans. The taxpayer sought to claim all the interest expense as deductions from its total dividend income as a whole. The CIT disagreed, instead allowing deductions of interest expense only if they were attributable to the specific share counters that produced income. The Court of Appeal agreed with the CIT and held that the taxpayer had erred in considering dividend income arising from a variety of share investment counters as collectively forming a single source of income against which interest expense was deductible.

4 2 *JD (CA)* did not draw a very clear line between the requirements of ss 14(1) and 14(1)(*a*) of the ITA. It appears that the primary discussion centered around the phrase "in the production of the income" in s 14(1). Nevertheless, the court cited *Andermatt*'s discussion on s 14(1)(*a*) and observed that the words "the income", rather than "any income", were used in both ss 14(1) and 14(1)(*a*) (at [47]). On this premise, the court stated that the direct link test must be assessed in relation to a particular source of income and not the taxpayer's income generally (at [47]):

> … This was also upheld in *Andermatt* where this court, at [27], endorsed the view that under s 14(1)(*a*), there must be a direct link between the money borrowed and the income produced. In our view, this link would clearly be broken if the dividend income arose from a share investment counter which purchase was not funded by the loan for which the related interest expense was sought to be deducted.

43 The third decision of the Court of Appeal citing the direct link test is *BFC*, where the court held that s 14(1)(*a*) was an exception to s 15(1)(*c*). The court explained the exception in the following terms (at [41]):

> … The effect of s 14(1)(*a*) is that if some "direct link" (see *Andermatt* […]) is established between the taxpayer's income and a loan of a capital nature on which interest is incurred, the interest payable on the loan is deductible even though it is capital expenditure.

44 Thus, the direct link test has found support in at least three Court of Appeal decisions and it is clear that the courts have accepted the direct link test as a universal test for s 14(1)(*a*). There was no indication of any desire or need for the direct link test to be departed from.

Universality of the test

45 In the present case, the Taxpayer contended that the direct link test is not the exclusive test for s 14(1)(*a*) of the ITA. There were two parts to its argument in this regard: first, that *Andermatt* should be narrowly construed and distinguished from the present case and second, that the causal inquiry read by the Judge into the direct link test is incompatible with *Andermatt* and the ITA's statutory framework.

46 We do not agree with either part of the Taxpayer's argument. In our judgment, although the direct link test may apply in different ways to different sets of facts, it is a test of general application under s 14(1)(*a*) of the ITA and it applies also to the present case.

47 The Taxpayer's argument proceeded on the erroneous assumption that the direct link test rested solely on the authority of *Andermatt*. Hence, its arguments focused on distinguishing *Andermatt* and challenging the other authorities cited in that case. We accept that *Andermatt* can be taken as authority for the narrower proposition that the direct link test would not be satisfied if

there was a mismatch between the source of income actually derived from the capital and the source of income from which a deduction was sought. This is supported by the facts of that case, where the overdraft was committed to the acquisition of the target company's shares whereas the deductions were sought against rental income from the property subsequently transferred to the taxpayer by a voluntary liquidation of that target company. Hence, the court observed that "[t]he purchase of the shares did not in itself vest the [property] or the rental income in the [taxpayer]" (at [29]) and that the fact that the property was mortgaged as security for the overdraft did not create a direct link where none otherwise existed (at [28]). The court also opined (at [32]) that the "circuitous route" of buying a property by acquiring then liquidating its holding company "gave rise to two different sources of income. Thus the missing link."

48 However, that does not mean that the direct link test is inapplicable beyond the facts of *Andermatt*. In our view, the direct link test is grounded in the statutory language of s 14(1)(*a*) and in particular, the words "capital employed in acquiring the income". The language of the provision states that deductions are allowed in respect of interest paid on "any money borrowed" amounting to "capital" that to the satisfaction of the CIT is "employed in acquiring the income". This imports necessarily the requirement of a nexus – which we agree can be articulated conveniently as a "direct link" – between the loan and the acquisition of the income. In practical terms, to establish the deductibility of an interest expense, the taxpayer should ordinarily be able to particularise how it had employed the borrowed funds in the acquisition of the income against which a deduction is sought. Therefore, we do not think that the general applicability of the direct link test can be contested seriously.

49 Insofar as *Andermatt* is concerned, the Taxpayer relied on the court's hypothetical observation (at [21]) that interest on the overdraft would have been deductible if it was sought against dividends derived from the target company's shares rather than against rental income from the property transferred. It was pointed out that based on the timeline of events, the taxpayer had acquired the shares of the target company on 8 December 1987 leaving an outstanding debt which was only satisfied subsequently by the overdraft taken out on 8 February 1998 (see [39] above). Strictly speaking therefore, as a matter of chronology, the overdraft could not have caused the earning of the dividend income. [note: 42]

50 In our view, *Andermatt* does not assist the Taxpayer. First, the court's observation on the deductibility of interest against dividend income was only intended to illustrate the point we made above (at [47]) that the source of the income matters in applying the direct link test. In that context, the chronological order of events may have weighed less heavily on the court's mind. Secondly, it is not clear if a causal nexus could not be said to have existed between the loan and the income in *Andermatt*.

51 Indeed, the facts of *Andermatt* can be viewed in a way that upholds the causal inquiry as necessary for, or at least relevant to, the direct link test. One option is to view the acquisition of the target company's shares and the taking out of the overdraft as parts of one transaction, despite a minor chronological gap between the two events. So conceived, the overdraft led causally to the earning of the dividend income. Another option is to view the "capital" that was used to acquire the target company's shares as the debt that arose on 8 December 1987 when the shares were acquired on credit, rather than the overdraft that was subsequently taken out on 8 February 1988 which was used to refinance the prior debt. If so characterized, a causal nexus would exist between the debt and the dividends from the acquired shares.

52 The Taxpayer further submitted that the causal aspect of the direct link test renders it incompatible with the ITA's scheme. This is because (a) capital can never be a "close" cause of

income insofar as capital represents the company's liability and can only lead to the production of income through the intermediary of an asset and (b) just as revenue receipts are chargeable with tax "regardless of causation", deductions should likewise be allowed without regard to causation.

53 We are not persuaded. First, even if the intermediary of an asset is required for a loan to be utilized in the production of income, that only affects the proximity of the causal nexus but not the fact that it is required. Second, there was no authority cited for the proposition that causal nexus is entirely irrelevant in determining the liability of revenue receipts to taxation. It is not clear how an item of receipt can qualify, for instance, as a gain or profit "from any trade, business, profession or vocation" or "from any employment" within the meaning of the limbs of s 10(1) of the ITA, if some form of causal nexus did not exist between the item and the trade, business, profession or vocation or employment. In the circumstances, we do not accept that the relevance of causation to the direct link test would make the test incompatible with the scheme of the ITA.

Representation and retention

54 We turn now to the Taxpayer's primary submission that capital would be "employed in acquiring the income" within the meaning of s 14(1)(*a*) if income-producing assets are retained and represented by the said capital.

55 At the outset, two preliminary points should be noted:

(a) The Taxpayer's initial argument in its written submissions was that this approach should be adopted in place of the direct link test. During oral submissions before us, however, counsel for the Taxpayer appeared to take the position that even if the direct link test applied, it would be satisfied because the interest was paid on a loan that retained or represented its income-producing assets. In essence, the Taxpayer maintained the same substantive submission whether or not the direct link test applied.

(b) Even though the Taxpayer conflated the two tests, we think it is conceptually neater to consider them separately: (i) whether capital is "represented" by income-producing assets ("the test of representation") and (ii) whether capital "retained" the taxpayer's income-producing assets ("the test of retention").

56 We now consider the proposed tests.

Capital represented the taxpayer's income-producing assets

57 In relation to the test of representation, we share the Judge's view (see HC Judgment at [14]) that it is not entirely clear what the Taxpayer meant by this test which the ITBR referred to as the "balance sheet test" (see [21(b)] above). In the Appellant's Case, the Taxpayer stated: [note: 43]

> … there subsists a necessary relationship between the capital of a business and the assets it holds. No asset of a business may be held without there being corresponding capital of equal value. This means that all assets of a business, whether newly acquired or long held, are funded by sufficient capital. In the judicial parlance adopted in the cases, the capital is thus said to be represented by the assets of a business …

58 In its Skeletal Submissions, the Taxpayer reiterated: [note: 44]

> … assets held represent the equity and loan capital and, if the assets are directed to the earning

> of income, both the loan and equity capital which they represented are devoted to the earning of income. Capital is thus "employed in acquiring the income" within the meaning of section 14(1)(*a*) where income-producing assets are retained by said capital. Acknowledging and applying this principle is not … applying a 'balance sheet presentation'.

59 Despite the above submissions, it appears to us that the test of representation is premised on the accounting equation that the total assets of a company are equal to the company's total liabilities and equity. In essence, the proposition put forth by the Taxpayer is that interest is deductible so long as it is payable on capital that appears on the same balance sheet as the taxpayer's income-producing assets.

60 In our judgment, there is no justification for the test of representation to take the place of the direct link test or to stand as an instance of when the direct link test would be satisfied. First, the test of representation does not comport with the statutory language of s 14(1)(*a*). As we mentioned above (see [38]), the operative phrase in the provision is "capital employed in acquiring the income". The mere fact that capital appears on the same balance sheet as the income against which a deduction is sought cannot satisfy the degree of activity in the commitment of capital and the procurement of income that is connoted by the terms "employed" and "acquiring".

61 We note that in the High Court, the Taxpayer submitted that the word "employed" is superfluous. It cited *Birmingham Small Arms Co Ltd v Inland Revenue Commissioners* [1951] 2 All ER 296 in which the House of Lords opined that there was no significant difference in meaning between the words "capital employed in a trade or business" and "capital of a trade or business" in the context of provisions for the computation of the amount of capital employed in a trade or business for the purposes of excess profits tax. This argument was not raised before us. In any event, we would have been inclined to agree with the Judge that the case should not be relied on because of its different statutory context (see HC Judgment at [15]).

62 Before us, the Taxpayer argued that the use of the word "in" as opposed to "to" or "for" meant that Parliament had intended s 14(1)(*a*) to require merely a "passive state of relation … rather than an active and direct causation or 'use'". [note: 45] Citing *Commissioner of Taxation of the Commonwealth of Australia v Day* [2008] 236 CLR 163 ("*COT v Day*"), the Taxpayer added that the High Court of Australia had construed the term "in" to mean "in the course of" in the context of an Australian deduction provision. [note: 46]

63 In our view, this submission is without merit. In *COT v Day*, the provision in question was s 8-1 of the Income Tax Assessment Act 1997 (Cth) which provided that a loss or outgoing was deductible from the taxpayer's assessable income to the extent that it was "incurred in gaining or producing" the assessable income. The Australian statute's use of "incurred in" compared to our s 14(1)(*a*)'s "employed in" is at least capable of showing a fine but appreciable distinction between the two statutory provisions. Our s 14(1)(*a*) connotes an active nexus between the loan and the income acquired. In any case, we do not see why *COT v Day* should cause us to abandon the established direct link test.

64 The test of representation also does not seem compatible with the term "the income" in s 14(1)(*a*). As the Court of Appeal noted in *JD (CA)* at [47], the phrase "acquiring the income" as opposed to "acquiring any income" connotes a clear nexus between the capital and the particular source of income from which a deduction is sought to be made. This requirement would not be satisfied under the test of representation.

65 The test of representation gives rise to a further concern that there would be undue reliance

on the balance sheet of the taxpayer. While accounting practices and rules are relevant in tax law, they do not necessarily dictate tax consequences. As Andrew Phang JA observed in *ABD Pte Ltd v Comptroller of Income Tax* [2010] 3 SLR 609, "[w]here ordinary accounting principles run counter to the principles of tax law, they must yield to the latter for the purposes of computing gains and profits for tax" (at [111]). The test of representation holds paramount the manner in which information is presented on the corporate balance sheet and does not appear to leave room for the tax authority to consider whether the requirements of s 14(1)(*a*) are satisfied. This could not have been the statutory intention when s 14(1)(*a*) expressly contemplates that the CIT must be "satisfied that" the interest is payable on capital employed in acquiring the income.

66 The Taxpayer also cited two cases in support of the test of representation but we think that neither can sustain the submission. The first case was *Yeung v Federal Commissioner of Taxation* (1988) 88 ATC 4193 [note: 47] ("*Yeung*"). There, a man and his wife contributed money to purchase real estate in their names as well as in the names of their children in circumstances which gave rise to a partnership within the meaning of s 6(1) of the Income Tax Assessment Act 1936 (Cth) ("Australian ITAA 1936"). Pursuant to the spouses' intention to withdraw from the partnership, the partnership borrowed from a third party and used the borrowed funds to repay the contributions that they had made. The broad issue was whether the partnership could deduct the interest expense incurred on the borrowed funds under s 51(1) of the Australian ITAA 1936 which provided as follows:

> All losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.

67 Davis J sitting in the Federal Court of Australia allowed the deduction. In framing the issue before him as whether the interest "was incurred in gaining or producing the assessable income of the partnership", it appears that the deduction was granted pursuant to the first limb of s 51(1) of the Australian ITAA 1936 (at 4202). In this regard, Davis J observed that it was "established that … under sec. 51(1) of the [Australian ITAA 1936], what is relevant is the purpose for which moneys borrowed were applied" (at 4202). On the facts, Davis J held as follows (at 4204):

> I am prepared to accept that from the partnership's point of view, what occurred was that two of the partners decided to withdraw funds from the partnership. It does not materially matter whether those funds were loan funds or capital which the partners had invested in the properties. The notional payment out to Dr and Mrs Yeung and the borrowing of an amount from [the third party] necessarily effected a change in the capital interest which each of the partners had in the partnership. What the partnership achieved by the borrowing from [the third party] was the maintenance of the income earning properties. Funds were withdrawn, but were replaced by loan funds and the income-earning properties remained held by the six members of the family.
>
> In an income-earning enterprise, both income and equity capital may be invested in assets directed to the earning of income. In such an event, if equity capital is repaid and loan capital replaces it, interest payable on the loan capital will ordinarily be an allowable deduction from the income derived from the assets. This is because the assets held represent the equity and loan capital and, if the assets are directed to the earning of income, then both the loan capital and the equity capital which they represent are devoted to the earning of assessable income.

68 Although Davis J used the word "represent", his factual analysis suggests that the relevant proposition to be extracted is not the test of representation but the test of retention, that is, the

principle that interest paid on a loan used to preserve or retain the taxpayer's income-earning assets is deductible, at least insofar as s 51(1) of the Australia ITAA 1936 is concerned.

69 In any event, *Yeung* is of limited assistance to the Taxpayer. Indeed, it appears on a brief survey of the Australian jurisprudence on interest deductibility that *Yeung* has been controversial even in Australia and may not accurately represent the state of the law.

70 In an earlier High Court of Australia case of *Federal Commissioner of Taxation v Munro* (1926) 38 CLR 153 ("*Munro*"), the issue was whether interest incurred on a loan that was not used to produce assessable income but was secured on an income-producing asset was deductible under s 23(1)(3) of the Income Tax Assessment Act 1922–1925 (Cth) ("Australian ITAA 1922"). The taxpayer argued that the interest expense was incurred in producing its assessable income because, if the interest was not paid, the income-producing assets may be jeopardized. The High Court unanimously rejected this argument. Isaacs J said at 197:

> … It is said for the [taxpayer] that, since it was necessary to pay the interest if the taxpayer wished to retain his right to have the income from the property, it was interest by which that income was gained or produced. I am not able to accept that view. The taxpayer had already acquired and held his property as a rent-producing property to the full extent. Nothing more was necessary to gain or produce that income. Then he chose for his own purposes quite alien to that property to borrow money and incur a personal obligation to repay it with interest. So far, also, the property stood complete as a rent-producing instrument. But because he secured his personal debt by means of that complete rent-producing instrument he contends that the discharge of the obligation was "actually incurred in gaining or producing" the rental it yielded. The simple position is that the property and its rentals existed before the loan and remained intact and unaltered after the loan. Had the money borrowed been expended on the property so as to increase the rentals or so as to prevent depreciation which would have reduced the rentals, then it could have been properly said that the interest had been a means of gaining or producing the assessable income. But in employing the borrowed money for purposes independent of the property, leaving its condition entirely unaffected, that result cannot be postulated.

71 *Yeung* was thereafter decided in 1988. Subsequently, in *Federal Commissioner of Taxation v J D Roberts and Smith* (1992) 92 ATC 4380 ("*Roberts*"), the Australian Federal Court was concerned with the deductibility of interest incurred by partners of solicitors who had taken out loans to allow a reduction of capital for existing partners of the firm. Hill J, writing the leading judgment for a unanimous court, held (at 4390) that:

> … The provision of funds to the partners in circumstances where that provision is not a repayment of funds invested in the business, lacks the essential connection with the income producing activities of the partnership or, in other words, the partnership business. Likewise, the interest incurred on the borrowing will not be incidental and relevant to the partnership business.

72 Hill J also said the following about *Yeung* (at 4389):

> … the result reached in *Yeung* seems clearly correct if the case is viewed simply as one involving a borrowing to fund the repayment of moneys originally advanced by a partner and used as partnership capital, particularly given that the original funds were used to purchase the rental property.

73 It appears from Hill J's statement that the principle to be drawn from *Yeung* is that if the business of a partnership was funded by moneys originally advanced by a partner as partnership

capital, interest paid on a loan used to repay that capital would be deductible. Nothing was said about whether the loan must "represent" the income-producing assets of the partnership. So read, *Yeung* does not advance the Taxpayer's case for a test of representation.

74 Subsequently, in *Hayden v Federal Commissioner of Taxation* (1996) 96 ATC 4797 ("*Hayden*"), the issue was whether interest on borrowing secured over an income-producing asset used to purchase a private asset was deductible. Spender J in the Federal Court was confronted with *Munro*, as against a line of cases including *Yeung* which purportedly supported the test of retention, *ie*, interest is deductible if the loan enabled the taxpayer to retain or preserve its income-producing assets. The court held that the two propositions could not be reconciled and that the Australian High Court decision in *Munro* was to take precedence. According, the court opined that:

> In my opinion, the fact that the borrowing of funds permitted income-producing assets to remain as part of the estate so that the income stream to the estate was not diminished, does not bring the interest on borrowings within a loss or outgoing under s 51(1) of the [Australian ITAA 1936].

75 The parties here did not address fully the implications of the line of Australian decisions on the position in Singapore although the Judge had expressly referred to *Roberts* in the HC Judgment at [26]. Nevertheless, in the light of the decisions in *Roberts* and *Hayden*, it is not clear that *Yeung* can be read as authority for the test of retention or if the test remains good law in Australia.

76 Furthermore, as we have emphasized before, in the area of tax law, foreign jurisprudence has to be considered carefully before it is adopted as part of local law. This is because tax law is primarily a creature of statute and must respond to local regulatory concerns. As the High Court reiterated recently in *Zhao Hui Fang v Commissioner of Stamp Duties* [2017] 4 SLR 945 at [78], "it is not generally helpful to selectively highlight dicta from foreign jurisprudence on the construction of particular terms in foreign tax statutes, even if those terms are *in pari materia* with local provisions … without an explication of the relevant context, history, and purpose of the foreign tax statutes and how those compare to the local regime in Singapore". There is also a factual distinction between *Yeung* and the present case which we will discuss subsequently in this judgment.

77 The second case cited by the Taxpayer in support of the test of representation was the New Zealand Court of Appeal's decision in *Pacific Rendezvous Ltd v Commissioner of Inland Revenue* [1996] 2 NZLR 567 ("*Pacific Rendezvous*"). [note: 48] In this case, the taxpayer which was in the business of operating motels took a loan for the renovation of its premises with the dual purpose of improving the sale price of the business and generating more revenue in the interim period prior to the sale. The renovation led to a substantial increase in revenue and also in capital gain. The issue was whether interest on the loan should be allowed to be deducted under s 106(1)(h)(i) of the Income Tax Act 1976 (NZ) which permitted the deduction of interest "so far as the Commissioner is satisfied that … [i]t is payable on capital employed in the production of the assessable income". The contention was whether the Commissioner was correct to allow only 25% of the interest expense to be deducted.

78 The New Zealand court held unanimously that all of the interest was deductible as there was no question that the loan was "expended on physical assets of the motel business, employed full-time in that business, and generating substantial revenue for the business" (at 575). Richardson J made the following remarks about the New Zealand statutory provision (at 572):

> … In concentrating on the employment of the borrowed capital rather than on the interest expended it proceeds on the premise that interest is paid for the use of the principal and is referable to the production of assessable income through the investment of principal moneys on

which it is paid. … "Employed" bears its plain ordinary meaning and is synonymous with "used". The difficulty lies in determining whether or not the statutory nexus is satisfied in the particular case. … [The phrase] "in the production of the assessable income" in s 106(1)(h)… will ordinarily involve essentially the same considerations in determining whether or not there is a sufficient connection between the expenditure of interest and the income earning activity involving the use of the property for the interest to qualify for deduction; and by implication that determining whether there is a sufficient relationship between the expenditure and what it provided or sought to provide on the one hand and the income earning process on the other so as to fall within the words of the paragraph becomes a matter of degree and so a question of fact…

However, I do not find it necessary to explore the depths which may be reflected in the use of the word "in" in that context in some other less clear-cut factual circumstances. This is because, if the focus is on the employment of the capital in the income earning process with the borrowings being represented here in the physical assets of the motel business, it is impossible to escape the conclusion that in each of the income periods those assets and that borrowed capital were employed in the production of the assessable income. Those assets were fully committed at all times to the regular motel business. They played a full part in generating the substantially increased revenue of the motel business in each income period. …

79 Two propositions can be gleaned from the above quotation:

(a) First, just as we observed above (at [46]) that s 14(1)(*a*) of the ITA requires a direct link between the loan and the income acquired, the New Zealand courts require a "sufficient connection" between the expenditure and the income-earning activity in order to qualify for deductibility of interest on that expenditure.

(b) Secondly, the reference to borrowings "being represented" by the physical assets of the taxpayer cannot be taken to justify the test of representation because it follows an express affirmation in the preceding paragraph that the statutory term "employed" bears its plain ordinary meaning and is synonymous with "used". Both terms connote some degree of activity in the commitment of the loan. The sentences that follow also concern the causes to which the loan-acquired assets are positively and actively committed rather than any question about the taxpayer's balance sheet.

80 In the circumstances, neither *Yeung* nor *Pacific Rendezvous* supports the test of representation advocated by the Taxpayer. There are also no local case authorities which support this test.

Capital retained or preserved the taxpayer's income-producing assets

81 The other legal premise of the Taxpayer's submissions is the test of retention which posits that capital is "employed in acquiring the income" within the scope of s 14(1)(*a*) if the taxpayer's income-producing assets are preserved or retained by such capital.

82 For present purposes, it is not necessary to lay down a general rule as to whether satisfaction of the test of retention would necessarily satisfy the direct link test. This is because even if the answer is in the affirmative, the Interest Expense did not satisfy the test of retention on the facts. We make the following tentative observations:

(a) It appears to us that one may argue that the test of retention is unjustifiably broad. Taken at face value, it suggests that interest on any loan taken to repay a debt owed by the taxpayer would be deductible because the loan aided in the retention or preservation of the

taxpayer's assets which may otherwise have been realized.

(b) It is not clear that the test of retention is consistent with the statutory language of s 14(1)(*a*).

(i) The word "acquiring" would suggest that the loan must be employed in a manner that is more actively income-generating than the mere preservation of income-producing assets.

(ii) The test of retention does not appear to be concerned with the use to which the loan is committed, because the mere taking out of the loan would have achieved the desired preservation or retention. Accordingly, the test may not account adequately for the word "employed" used in s 14(1)(*a*).

(iii) There may be difficulty reconciling the test of retention with the current jurisprudence on "the interest" which requires a nexus between the capital and the particular source of income from which a deduction is sought. It may be that in some circumstances, the taxpayer would be able to identify particular assets and/or sources of income preserved by the capital or the loan but that is unlikely to be the case generally.

(c) On its face, *Yeung* supports the test of retention. However, for reasons we have discussed above, it is not clear that any reliance can be placed on the case. No other case was cited to us which could support this test.

Application of the direct link test

83 On the facts, the Taxpayer submitted that the Interest Expense qualified for a deduction under s 14(1)(*a*) because the Shareholder Bonds retained the Taxpayer's income-producing assets, *ie*, the Mall and the Shareholder Advances, and were represented by the same. [note: 49]

84 We do not agree. As we have explained, the test of representation does not comport with the statutory language of s 14(1)(*a*) and is not supported by case authority. Therefore, the mere fact that the Shareholder Bonds are said to "represent" or appear on the same balance sheet as the Mall and the Shareholder Advances does not satisfy the direct link test.

85 As for the test of retention, even assuming that the direct link would be satisfied if this test was met, we are of the view that the issuance of the Shareholder Bonds could not be said to have retained or preserved the Taxpayer's income-producing assets. To say that a loan retained or preserved certain income-producing assets implies that there must have been at least a material risk of the assets being sold, realised or otherwise taken away from the taxpayer if the loan was not taken out. Conversely, if the assets would have been retained or preserved in any event whether the loan was taken out or not, then it is not logical to say that the loan enabled or contributed to the retention or preservation of the assets in any meaningful way.

86 In the present case, the Shareholder Bonds could not be said to have retained or preserved the Taxpayer's Mall or the Shareholder Advances as there was no material risk that the Taxpayer's income-producing assets would have been taken away if the Shareholder Bonds had not been issued. As the ITBR found and the Judge agreed, it was highly improbable that the Shareholders would have sued on the debt owed to them by the Taxpayer after the Capital Reduction Exercise. In this regard, the following evidential points are notable:

(a) First, a director of the Taxpayer who testified before the ITBR conceded under cross-

examination that there was no material risk that the Taxpayer would be compelled to sell the Mall to repay its debt to the Shareholders. This concession was made when the director was asked why the information memorandum accompanying the issuance of the Shareholder Bonds did not state any risk of the Mall being sold to satisfy the Taxpayer's debt to the Shareholders: [note: 50]

Q So, … if there is a material risk that the mall may be sold to satisfy debt owing to the shareholders, it would have to be stated and it is not stated [in the information memorandum].

A At time—at that point there is no material risk as you have mentioned.

(b) Second, the purpose of the capital restructuring exercise was to provide the Shareholders with a stream of interest income. [note: 51] This objective could not be achieved if the Shareholders sued on the debt to compel the Taxpayer to dispose of the Mall or to assign the Shareholder Advances for consideration. In this regard, a director of one of the Shareholders [note: 52] agreed in cross-examination that the "exclusive purpose" of the issuance of the Shareholder Bonds was to provide a return to the Shareholders. [note: 53] He also conceded and repeated that it was "never our intention" for the Taxpayer to realise or dispose of the Mall [note: 54] and that save in situations involving "an act of God or earthquake or whatever it is", [note: 55] the intention had always been for the Taxpayer to continue owning and operating the Mall. [note: 56]

(c) Third, given that the Shareholder Bonds were unsecured instruments and that the Mall had been securitised to its full value in relation to the WM Loan (see [6] above), it is inconceivable that the Shareholders would have sued on the debt when a realisation of the Taxpayer's main asset would not yield much to them.

87 In the circumstances, we found no reason to question the ITBR's rejection of the Taxpayer's argument that the issuance of the Shareholder Bonds retained or preserved the Taxpayer's income-producing assets (see ITBR Judgment at [28]). Since the Shareholders would not have enforced the debt against the Taxpayer in any event, it did not matter that the Shareholder Bonds provided some structure to the debt repayment timelines (see [14] above) or that the Taxpayer may not have had sufficient funds on hand to immediately fulfil its debt to the Shareholders on completion of the Capital Reduction Exercise. [note: 57]

88 Given the manner in which the Taxpayer had run its case, the appeal must fail if we reject the test of representation as a matter of law and the Taxpayer could not satisfy the test of retention on the facts in any case. For completeness, we should also mention that we find the following factors relevant to the application of the direct link test:

(a) There was no observable change in the Taxpayer's rental or interest income after the issuance of the Shareholder Bonds. The director of one of the Shareholders agreed that the Shareholders could have chosen not to receive interest on the Shareholder Bonds and the Mall would still have produced the rental income. [note: 58] The Taxpayer's director conceded that the Shareholder Bonds did not make a difference to the operation of the Mall. [note: 59] It is also clear that the Shareholder Bonds did not affect the interest received by the Taxpayer on the Shareholder Advances.

(b) The Shareholder Bonds did not lead to the acquisition of any new asset by the Taxpayer. We agree with the Taxpayer that such an acquisition is not a requirement under s 14(1)(*a*) which focuses on the acquisition of "the income" rather than that of an asset. [note: 60] However, that does not mean this factor is not relevant evidentially in determining whether the loan qualifies as "capital employed in acquiring the income". Further, the Shareholder Bonds also did not lead to the improvement of any of the Taxpayer's existing income-producing assets, such as through renovation or upgrading of the Mall.

(c) There is no identifiable causal nexus between the Shareholder Bonds and the rental income from the Mall or the interest income from the Shareholder Advances. As discussed above, such a causal nexus is needed to satisfy the direct link test.

(d) The Shareholder Bonds were not issued for the purpose of income-generation in the first place. We agree with the Taxpayer that the language of s 14(1)(*a*) suggests that the direct link test is concerned with an objective state of affairs rather than the taxpayer's subjective intentions. [note: 61] However, this is not to say that the purpose of a transaction or the intention of the taxpayer does not have evidential value. In this regard, we agree with the following passage from *Pacific Rendezvous* (at 573):

> On an ordinary reading of s 106(1)(h) in its statutory context I can see no justification for a gloss of that kind which would seem to involve shifting the statutory focus away from how the capital was actually employed … to the underlying purpose of the taxpayer in raising and utilising the loan moneys. Certainly the taxpayer's purpose may bear on the consideration of whether it can fairly be said that the capital has been employed in the production of assessable income. It cannot, however, be invoked to deny the conclusion that the capital was employed in that way. …

(e) The Shareholder Bonds replaced a debt of the same amount and involved no actual flow of funds. It therefore did not improve the cash flow or liquidity of the Taxpayer.

89 Before the ITBR, the Taxpayer appeared to have taken the position that deduction was sought against only its rental income from the Mall. Hence, the sole issue related to the direct link between the Shareholder Bonds and the rental income (see ITBR Judgment at [9]). [note: 62] However, on appeal to the High Court [note: 63] and before us, the Taxpayer framed the deduction as against both the rental income of the Mall and the interest income of the Shareholder Advances. We do not think that the Taxpayer is entitled to make this belated change of position. In any event, the Taxpayer did not attempt to explain how the Shareholder Bonds helped it to retain the Shareholder Advances. This is a further reason why the direct link test is not satisfied, at least insofar as the interest income from the Shareholder Advances is concerned.

90 The Taxpayer also argued that the CIT's discretion under s 14(1)(*a*) of the ITA, which is expressed in the words "where the Comptroller is satisfied", does not permit the CIT to go beyond the statutory test and consider irrelevant factors. In our view, this proposition is self-evident and does not assist the Taxpayer. In the present case, the CIT did not go beyond the statutory test, which we have affirmed to be the direct link test, and no irrelevant factor was considered. As a general matter, the CIT has the discretion to engage in a fact-finding exercise to determine whether the direct link test is satisfied. It is for the Taxpayer to persuade the court that the CIT had acted on the wrong principles or had misapprehended the facts or any inferences to be drawn from those facts. The Taxpayer has not done so.

The purportedly analogous authorities

91 Finally, we consider three case authorities cited by the Taxpayer in support of its case that the Interest Expense is deductible.

The hypothetical observation in Andermatt

92 The Taxpayer tried to rely on the court's hypothetical observation in *Andermatt*, which has been discussed above at [49], that interest on the overdraft would have been deductible if it was sought against dividends derived from the target company's shares, rather than against rental income from the property transferred. The Taxpayer noted that both *Andermatt* and the present case involve the voluntary incurring of debt by the taxpayer and the raising of debt capital to satisfy a prior debt, with interest on the new debt sought to be deducted against income derived from the company's pre-existing assets. There was therefore no rational basis for distinguishing the present case from the hypothetical. [note: 64]

93 In our view, the hypothetical observation in *Andermatt* is clearly distinguishable from the present facts. There, an overdraft was used to repay a prior debt incurred in the acquisition of shares and interest on the overdraft was sought to be deducted against dividend income from those acquired shares. Apart from a minor chronological gap, there was no question that a direct link existed between the overdraft and the dividend income because a new income-producing asset was acquired using borrowed funds that were obtained by the taxpayer from a third party for the purpose of that acquisition. In the present case, however, no new asset was acquired, no improvement was made to existing assets, no material risk of realization or loss of the Taxpayer's income-producing assets existed even if the Shareholder Bonds were not issued, no funds were transferred between the creditor and the debtor, and no identifiable causal nexus existed between the Shareholder Bonds and the Taxpayer's rental or interest income. Seen in this light, the two situations were materially different.

Yeung

94 The Taxpayer's second analogy concerned *Yeung*. The facts and decision in *Yeung* have been summarised above (see [66] to [67]). To reiterate, a deduction was allowed under s 51(1) of the Australian ITAA 1936 in respect of interest paid on a loan taken out to replace capital which certain partners had sought to withdraw from a partnership. In our view, *Yeung* can be distinguished from the present case because there was a material risk there that, after the withdrawal of capital by the partners, the income-producing assets of the partnership would have to be sold or realised if the loan had not been taken out. Therefore, Davis J found on the evidence that "[w]hat the partnership achieved by the borrowing from [the third party] was the maintenance of income earning properties" (at 4204). The evidence in the present case was, however, plainly incapable of supporting a similar finding. In fact, the evidence is to the contrary as it was conceded by the Taxpayer that there was no such material risk.

Zeta Estates

95 The third case cited was *Zeta Estates*. In that case, the taxpayer was in the business of purchasing and developing real estate for rent and sale. The bulk of its real estate portfolio was financed by accumulated profits ($408m) and interest-free shareholders' loans ($454m). The taxpayer's directors declared dividends of $400m. The dividends were not paid in cash but by a series of accounting entries, credited to the accounts of its shareholders as interest-bearing loans. The

taxpayer sought to deduct the interest on these loans from its assessable profits. The Commissioner disallowed the deduction under s 16(1)(a) of the Inland Revenue Ordinance (Cap 112) (HK) ("HK IRO") which provided as follows:

> (1) In ascertaining the profits in respect of which a person is chargeable to tax under this Part for any year of assessment there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period, including:
>
> > (a) Where the condition for the application of this para is satisfied under sub-s (2) … sums payable by such person by way of interest on any money borrowed by him for the purpose of producing such profits.

96 The Hong Kong Court of Final Appeal allowed the deduction. In particular, Lord Scott stated the following (at [19]) and the Taxpayer here relied heavily on this passage: [note: 65]

> The effect of the directors' decision to declare the dividend was, given the illiquid state of Zeta, to produce a need for the payment of the dividend to be funded. Zeta had only two ways of doing so. Either Zeta would have to sell sufficient of its profit-earning assets to pay the dividends … or Zeta would have to borrow a sufficient sum to pay the dividends. That these were Zeta's only options is apparent from its … accounts. It chose the borrowing option, *ie* it chose to fund the payment of the dividend by raising fresh working capital rather than by selling profit-earning assets, using the proceeds of sale and thereby reducing its working capital. The Board's conclusion that … there was no evidential basis to support the argument that fresh working capital was needed … must either have been based on a fairly fundamental misunderstanding of Zeta's … accounts or on the misconceived notion that if the dividends could not be paid without either selling assets or borrowing the dividends ought not to have been declared.

97 We do not think *Zeta Estates* assists the Taxpayer's case. First, s 16(1)(a) of the HK IRO is materially different from our s 14(1)(*a*) in at least two respects.

> (a) s 14(1)(*a*) focuses on whether the loan is "employed in acquiring the income" as an objective state of affairs. In contrast, s 16(1)(a) of the HK IRO uses the phrase "for the purpose of producing such profits".
>
> (b) s 16(1)(a) of the HK IRO does not provide for the Commissioner's discretion in assessing the satisfaction of the statutory nexus test. Therefore, the deference that needs to be accorded to the CIT did not feature at all in *Zeta Estates*.

98 In any event, *Zeta Estates* is also distinguishable from the present case on the facts. Based on Lord Scott's exposition of the facts, it is evident that there was a material risk that the taxpayer's income-producing assets would have been sold or realised if the borrowing in question had not been taken out. Indeed, Lord Scott found that given the illiquid state of Zeta, Zeta only had the two options of either being compelled to sell its assets or to take out the loan. In contrast, in the present case, there was no material risk that the Shareholders would have called upon the debt which arose from the Capital Reduction Exercise even if the Shareholder Bonds were not issued. As admitted by the Taxpayer before the ITBR, there was no real threat to the continued operation of the Mall. This was an indulgence which the taxpayer in *Zeta Estates* did not enjoy.

99 In the circumstances, there is no analogous authority to support the Taxpayer's case on the

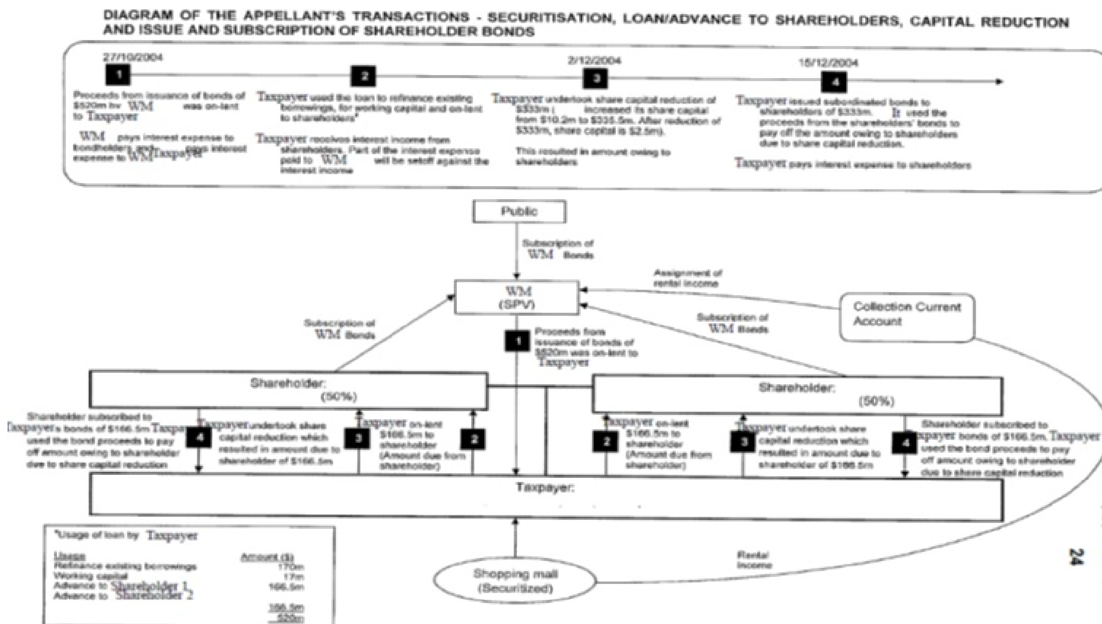
deductibility of the Interest Expense.

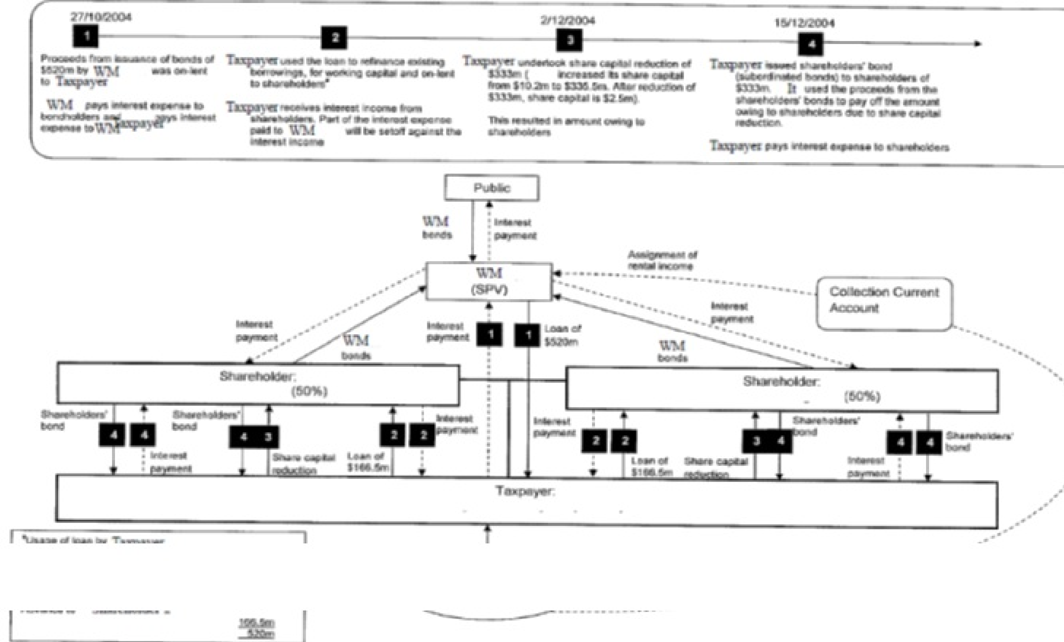
Conclusion

100 For the foregoing reasons, we dismiss the Taxpayer's appeal with costs. In the respective costs schedules, the CIT submitted a total of $20,000 (inclusive of disbursements) as his costs for this appeal while the Taxpayer asked for $80,400 as costs and $4,277.70 as disbursements. We think the amount that the CIT has asked for is more than fair in the circumstances. We therefore order the Taxpayer to pay the CIT the costs of this appeal fixed at $20,000 inclusive of disbursements. We also make the usual consequential orders on the security for costs provided by the Taxpayer.

101 Finally, we note that the CIT allowed the interest paid by the Taxpayer to WM on the WM Loan to be deducted as he was of the view that there was a direct link between the WM Loan and the rental income (see ITBR Judgment at [30]). We agree with the ITBR when it stated, "The [ITBR] agrees with the [CIT] that the adoption of the Balance Sheet Test, assuming it was intended in *Zeta* to lay down such a test, will result in the absurdity of the [Taxpayer] being allowed to claim a deduction of interest for both the loan from [WM] and the Shareholder Bonds, which in aggregate exceed the value of the Mall at the material time, when the required 'direct link' has not been shown in respect of the full amount thereof" (see ITBR Judgment at [38]).

Annexures





[note: 1] ROA Vol 3, Part A at p 244.

[note: 2] ROA Vol 3, Part A at pp 244–245.

[note: 3] ROA Vol 3, Part A at pp 113–155; ROA Vol 3, Part A at p 110.

[note: 4] 2CB6.

[note: 5] 2CB6; ROA Vol 3, Part A at p 178.

[note: 6] ROA Vol 3, Part A at p 6.

[note: 7] Respondent's Case at para 4; ROA Vol 3, Part A at p 110.

[note: 8] ROA Vol 3, Part A at p 246.

[note: 9] Respondent's Case at para 2(b).

[note: 10] ROA Vol 3, Part A at p 110.

[note: 11] ROA Vol 3, Part A at p 6.

[note: 12] 2CB7.

[note: 13] Respondent's Case at para 6; ROA Vol 3, Part A at p 31; ROA Vol 5, Part B at p 66.

[note: 14] ROA Vol 3, Part A at pp 18–19.

[note: 15] ROA Vol 5, Part B at pp 4–9.

[note: 16] ROA Vol 5, Part A at p 4.

[note: 17] ROA Vol 3, Part A at p 7.

[note: 18] ROA Vol 3, Part A at pp 8 and 42.

[note: 19] 2CB9.

[note: 20] ROA Vol 5, Part A at p 5; ROA Vol 3, Part A at pp 42–43 (cl 3.2 of the Resolution).

[note: 21] ROA Vol 3, Part A at p 8.

[note: 22] ROA Vol 3, Part A, p 7.

[note: 23] 2CB7; ROA Vol 3, Part A at p 50.

[note: 24] 2CB7.

[note: 25] ROA Vol 3, Part A at p 50.

[note: 26] ROA Vol 5, Part A at pp 6–7.

[note: 27] ROA Vol 5, Part A at p 6.

[note: 28] ROA Vol 5, Part A at p 7.

[note: 29] ROA Vol 2 at pp 7–10.

[note: 30] ROA Vol 2 at pp 3–4.

[note: 31] Appellant's Case at para 42.

[note: 32] Appellant's Case at para 6.

[note: 33] Appellant's Case at para 110.

[note: 34] Respondent's Case at para 12.

[note: 35] Respondent's Case at para 13.

[note: 36] Respondent's Case at para 22.

[note: 37] Respondent's Case at para 34.

[note: 38] Respondent's Case at para 77.

[note: 39] Respondent's Case at para 37.

[note: 40] Respondent's Case at para 85(b).

[note: 41] Respondent's Case at para 82.

[note: 42] Appellant's Case at paras 25–26.

[note: 43] Appellant's Case at para 31.

[note: 44] Appellant's Skeletal Submissions at para 13.

[note: 45] Appellant's Case at para 35.

[note: 46] Appellant's Case at para 34.

[note: 47] Appellant's BOA at Tab 16.

[note: 48] Appellant's BOA at Tab 12.

[note: 49] Appellant's Skeletal Submissions at paras 12–17; Appellant's Case at paras 29–39.

[note: 50] ROA Vol 3, Part B at p 190.

[note: 51] ROA Vol 3, Part B at pp 91 and 190.

[note: 52] ROA Vol 3, Part B at pp 125–126.

[note: 53] ROA Vol 3, Part B at p 91.

[note: 54] ROA Vol 3, Part B at pp 81, 113 and 114.

[note: 55] ROA Vol 3, Part B at p 82.

[note: 56] ROA Vol 3, Part B at pp 79 and 99.

[note: 57] Appellant's Case at para 70.

[note: 58] ROA Vol 3, Part B at p 123.

[note: 59] 2CB27.

[note: 60] Appellant's Case at paras 46–50.

[note: 61] Appellant's Case at paras 90–95.

[note: 62] See also ROA Vol 3, Part E at p 139.

[note: 63] See ROA Vol 3, Part D at p 159.

[note: 64] Appellant's Case at paras 43–45.

[note: 65] Appellant's Case at para 3.

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