THE SOURCE OF INTEREST: SECTION 10 AND SECTION 12(6) OF THE INCOME TAX ACT

Chandos Pte. Ltd. v. Comptroller of Income Tax[1]

Introduction

THE amount of interest payable as a return on a loan and the borrower's creditworthiness are factors foremost in the mind of a lender. The incidence of tax on the interest paid for the loan either on the lender or borrower is another important factor.[2] Whether interest is subject to tax in Singapore depends on whether it has accrued in, or is derived from Singapore, or received in Singapore. This is the effect of section 10(1), the charging section of the Income Tax Act.[3] Whether it is derived in Singapore may also depend on whether any of the statutory rules in section 12(6) of the Act applies.

Where income is received in Singapore the situation is fairly clear[4] since it comes within the purview of the words in section 10. It is the second basis on which interest could be subject to tax which is uncertain. Interest would be subject to tax if it is accrued or derived in Singapore. The Privy Council held that the terms "accruing" or "derived" were to be treated synonymously[5] and it is generally agreed[6] that the words "derived from" in section 10 refers to the concept of "source" although there is no reference to "source" in the Act. If the interest has its source in Singapore it is subject to tax. However, there is no definition given in the Act and there was no guidance from the courts in Singapore[7] on how the question, whether any income has its source in Singapore, is to be determined. The source rules laid down by cases from other jurisdictions are not as clear as may be desired.[8] The determination of the source of interest is itself a difficult task, apart from the problems of the source rules. The statutory rules in section 12(6) were enacted for the purpose of alleviating these difficulties. These rules ennumerated instances when interest is deemed to derive from Singapore; *i.e.,* they are statutory deemed source rules. However, these rules have not clarified the matter since the rules themselves and section 10 had not been the subject of judicial

1 [1987] 2 M.L.J. 670.

2 See, *e.g.,* Philip Wood, *Law and Practice of International Finance* (1980) and Andrew Ang, "Some Tax Implications in Financing Arrangements: An Examination of the Singapore Position" in *Current Issues of International Financial Law* (1985 D. Pierce & Ors. ed) 384 at p. 384; the borrower might consider the tax burden for the interest important since he would be under an obligation to withhold the tax payable.

3 Cap. 134, 1985 Rev. Ed., hereafter referred to as "the Act".

4 See Soon Choo Hock, "Tax Jurisdiction of Singapore" (1985) 27 Mal. L.R. 29, 56-61.

5 *Commissioner of Taxation* v. *Kirk* [1900] A.C. 588 at p. 589; but see Soon Choo Hock, *supra,* n. 4 at pp. 30-31 who pointed out there is a subtle difference indicated by another Privy Council decision.

6 Soon Choo Hock, *supra,* n.4 at p. 31; Andrew Ang *supra, n.2* at p. 385; Sat Pal Khattar, "The Concept and Determination of Sources of Income: Income from Trades, Businesses, Professions or Vocations" in *Proceedings of the Singapore Concise Tax Programme* (Oyez Longman 1984) 5 at p. 5.

7 *Ibid.*

8 Soon Choo Hock, *supra,* n.4 at p. 46.

scrutiny and interpretation until the recent decision of the High Court in *Chandos Pte. Ltd.* v. *Comptroller of Income Tax*[9] where the uncertainty about the manner these provisions would be applied to interest may have been laid to rest. This decision may resolve the uncertainty some foreign lenders may have felt about the incidence of tax on prospective loans they may make to Singaporean borrowers.

The Facts

Chandos Pte. Ltd. ("Chandos") was the "lender" company. It was incorporated in Singapore with one local resident director while the rest of the directors resided in Hongkong. Its holding company was a company incorporated in Hongkong which owned all its shares. One object of the company was the negotiation and procurement of capital for any company in any country. It was in relation to this object and the company's only one such transaction that the matter arose. The income of the company was to be from such transactions. The transaction in question involved Delacom Investments Pty. Ltd. ("Delacom"), a company incorporated in Australia (N.S.W.), which required a loan of S$9 million for the purchase of an interest in mineral rights in Australia. A loan agreement was entered into whereby Chandos would lend Delacom the sum which Chandos would in turn obtain through its overdraft facility with Banque Nationale de Paris ("B.N.P."). Delacom would then use this to pay a third company, Nazly Pura, for the mineral rights it was acquiring.

The directors of Chandos approved the transactions at a meeting held in Hong Kong as were all their directors' meetings. The signing of the loan agreement and the transfer of the sum of money took place in Johore Bahru. The representatives of Chandos and Delacom met there and signed the agreement. The cheque drawn on the Chandos B.N.P. account was handed over to Delacom who in turn drew a cheque for the same amount on their bank which was the same branch of B.N.P. which they then paid to Nazly Pura in Johore Bahru. Back in Singapore, the various cheques were credited in the respective accounts. The representative of Nazly Pura then "banked" the cheque into the company's account also with the same branch of B.N.P..[10]

The interest payable on the loan was determined by Chandos from time to time. Delacom would capitalise the interest from time to time in accordance with the agreement and reflect this as an amount in their account books in Australia. Effectively no payment was rendered to Chandos, except for some sums paid to the directors of Chandos as directors' fees. Delacom withheld the amount of tax payable on the amount of interest in the company accounts due to the Australian tax authorities.

The matter of contention was the assessment by the Comptroller of Income Tax (Singapore) of the income received by Chandos by way of interest on the loan. At the tax appeal tribunal stage, Chandos's objection was dismissed. The Board of Review held that the source of income, the interest, was Singapore since the origin of the funds was

9 [1987] 2 M.L.J. 670.

10 This was the inference drawn by Thean J. from the agreed statement of facts. See *Chandos, supra,* n. 1 at p. 677G.

the amount in the account of Chandos in B.N.P.. Alternatively, if Johore Bahru was material in the determination of source, the board held that the funds provided by loan had been brought into Singapore and thus the interest is deemed to have a source in Singapore by section 12(6)(b).

Chandos appealed to the High Court, Thean J. heard the appeal. Counsel for Chandos argued that interest was not income derived from Singapore drawing on decisions on source in other jurisdictions. He also argued that the board had erred since the funds were in an account in Singapore it could not be said that the loan had been brought into Singapore and thence section 12(6)(b) applying.[11]

The Decision

Thean J. decided the matter by first considering the concept of source as it applies to interest, and then proceeding to consider the application of section 12(6) of the Act. Regarding the concept of source, he discussed two decisions referred to by counsel for both parties as they were relied on extensively in their arguments. They were *Commissioner of Inland Revenue (N.Z.)* v. *N. V. Philips Gleilampenfabrieken,*[12], and *Commissioner for Inland Revenue* v. *Lever Brothers & Unilever Ltd.*[13] Counsel for Chandos had relied on certain of the judgments whilst opposing counsel representing the Comptroller chose other judgments. He found the judgments in *Philips* unhelpful as the judges were not in agreement as to the source of interest, although they were in agreement that on the facts of that case the income did not have its source in New Zealand.

He found that the interest had its source in Singapore by applying Issac J.'s approach in *Nathan* v. *Federal Commissioner of Taxation,*[14] namely, that the determination of source is a "practical hard matter of the fact". In the process he approved the dicta of Watermeyer C.J. in *Lever* where he had identified the source of interest to be "the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the quid pro quo which he gives in return for which he receives them." He considered the facts, isolating the material facts and decided in favour of the Comptroller.

Thean J. found the material facts to be the origin of the loan which was the overdraft facility granted to Chandos in Singapore, the performance of the loan which hinged on the use of the funds and therefore the clearance of the cheques in Singapore, and finally the disbursement of a sum in Singapore currency which was credited to the account of Delacom with the same branch of B.N.P.. In relation to the performance of the contract he found the execution and performance of the agreement in Johore Bahru "too superficial and also artificial". Thean J. concluded that "(g)iven all these facts, it just cannot possibly be argued that a practical man would regard the source of income in respect of the interest as not being in Singapore."

[11] Their arguments were not directly mentioned by Thean J.. The arguments are inferred from the judgment.
[12] 10 A.T.D. 376.
[13] [1946] 14S.A.T.C. 1.
[14] (1918) 25 C.I.R. 183.

Turning to section 12(6) Thean J. found that the interest, though not falling in the first part of section 12(6)(b) as argued by Chandos, still fell within the second part as it was used in Singapore. He held that the word "use" had no definition in the Act and was capable of "a wide import". Adopting the definition in an English decision,[15] he found that the disbursement of the loan in Singapore and the transfer to the account of Nazly Pura brought the interest within the section.

Comments

This is the first local decision on section 12(6) and on the concept of source under the Act. In it, Thean J. has confirmed some of the views of practitioners and writers on the concept of source. Prior to the decision, it had been the firm belief that section 10 of the Act referred to the "source" basis of taxation and many had relied on cases from Australia and South Africa in seeking an understanding of the concept as it applies to Singapore. The learned judge's reference to decisions from those jurisdictions verifies the wisdom of their reliance. Thean J. for instance confirmed that the words "derived in" did point to taxation on the "source" basis. However, there were other aspects where the court departed from the earlier views.

The first observation to be made about the decision concerns the approach adopted by Thean J. in determining the tax liability for interest income. He referred to the tests suggested by case law, namely, the "practical hard matter of fact" and "the originating cause" tests. However, with the presence of the statutory deemed source rules in section 12(6), the logical commencement of the inquiry should be with the section. If the section applied, it would not be necessary to refer to case law. Moreover, with section 12(6), there were few situations where reference need be made to the tests at common law.[16] This is because section 12(6) has a very wide ambit.[17] It is not confined to interest but extends to other aspects of investment income.[18] For a situation to fall outside the section, the payment must be borne by a non-resident, not be deductible against any domestic source income and the funds provided by the loan must not be brought into or be used in Singapore. Section 12(6) provides:

> "There shall be deemed to be derived in Singapore:-
>
> (a) any interest, commission, fees or any other payments in connection with any loan or indebtedness or with any arrangement, management, guarantee, or service relating to any loan or indebtedness which are —
>
> (i) borne directly or indirectly by a person resident in Singapore or a permanent establishment in Singapore except in respect of any business carried on outside Singapore through a permanent establishment outside Singapore or any immovable property situated outside Singapore; or

[15] *Shell-Mex and B.P. Ltd.* v. *Clayton* [1955] 3 All E.R. 102 *per* Evershed M.R.
[16] Soon Choo Hock, *supra,* n.4 at p. 39.
[17] Andrew Ang *supra,* n.2, p. 387 and Soon Choo Hock, *supra,* n.4, p. 39.
[18] S. 12(6) refers to commissions, fees payable in connection with any loan *etc.,* all of which have the common denominator as income being derived from investment.

(ii) deductible against any income accruing in or derived from Singapore; or

(b) any income derived from loans where the funds provided by such loans are brought into or used in Singapore."

The second observation concerns Thean J.'s approach to the determination of the source of interest under section 10. Should one consider the source rules suggested by the cases it would seem that Thean J. has not really applied any of them for most of the cases use one determinant whereas the learned judge's approach is to look at the various facts in a manner not dissimilar from an inquiry into what is the "proper law of a contract" in private international law. Some elaboration is necessary on this. The source rules suggested by case law have been very neatly categorised by one writer[19] as suggesting three tests: the location of the capital which was employed to produce the profit, or the activities which earned the funds, out of which the investment income was paid, or the location of the debt *(i.e.* where the debtor resides). The cases support either one of the three tests and in their approach the courts in the cases adopted one test, one factor which was crucial rather than a number of factors. The analogy, to the test for the "proper law of a contract" arises because in private international law when the question of the proper law of the contract arises the court looks for connecting factors and the law of the jurisdiction with the most connecting factors is the applicable law. Thean J. seems to be doing the same as he identified the material facts and found that they indicated Singapore as the source. This approach prompts the question whether Thean J. has introduced a new test — a balancing of factors under the guise of the "practical hard matter of fact" test. Such an approach prompts uncertainty.

That this approach is a departure from that taken by the cases can be seen by examining the approach taken in the decisions referred to by the court in *Chandos.* There is dicta in *Philips, Lever* and *Nathan* suggesting the "originating cause" and "practical hard matter of fact" tests. These were expressions of a general approach and definitions of source in general. They are in no way expressions of the determining factor to be used in the consideration of interest. In *Lever* for example, it was held that the source or originating cause of interest payable on loan of money was not the debt but the services that the lender performs to the borrower.[20] Watermeyer C.J. identified this to be the "provision of credit".[21] Hence the "originating cause" is the general test but the determining factor is the provision of the credit.[22] The court's approach in identifying the provision of the credit is to look at the facts and view them as a practical man would. In *Nathan,* when Issac J. said the approach would be as a practical man would view the facts, he did not state that there could be no determinants with respect to the source of each type of income. It appears that he is stressing that the question will always involve the scrutiny of facts which have to be evaluated practically, whatever that word "practically" may connote. He himself advocated one factor to determine whether dividend

19 Soon Choo Hock, *supra,* n.4.

20 Silke, Divaris and Stein, *Silke on South African Income Tax* (10th edition 1982; updated by supplements) para. 5.10.

21 *Lever supra,* n. 13 at pp. 9-10.

22 See discussion in Silke, Divaris and Stein, *op. cit.,* para. 5.3.

income had its source in Australia, the issue before him in *Nathan.* He was of the view that the fund out of which the dividends were paid is the source of the income.[23] The location of the fund is the source. This fund in turn would depend on the activities of the company which generated the fund. If such activities were in Australia then the dividend had its source there; if not, there was no liability for tax. In *Philips,* though the judges were not agreed in their treatment of the facts, being unable to agree unanimously on the country of source, they were agreed that the source of the interest was the activity which led to the obligation to pay the interest, or phrased differently, the provision of the credit. They had, as Thean J. mentioned, "quoted with approval, certain passages of the judgment of Watermeyer C.J.". The key passage was one wherein Watermeyer C.J. said "(c)onsequently this provision of credit is the originating cause or source of the interest received by the lender."[24] This was followed by a subsequent passage where the source of interest was elaborated to refer to "the making and carrying out of the agreement".[25] It is strange that after a detailed analysis of the decisions,[26] the learned judge did not single out a determining factor from among those used.

It is possible to mistake certain passages of Thean J.'s judgment as indicating his use of a determining factor. This arises because he adopted the words of Watermeyer C.J. in his discussion of the material facts.[27] However, this reference to the dicta was merely comestic. He was examining the facts surrounding the agreement and its performance, and had seemingly borrowed Watermeyer C.J.'s dicta to phrase his argument. Although he employed the words "adopting the words" and "using the words", he was not adopting the words as embodying a test. He concluded that the material fact was the actual disbursement of the loan denominated in Singapore currency, which was provided under the contract. There are two other reasons which render the proposition that Thean J. had adopted a determining factor untenable. Firstly, the context clearly indicates that in his mind he was considering the facts as a practical man would to see where was the source the material facts indicated to. The discussion began with the words "the material facts indicating the source of interest... are these" and concluded with the words "(g)iven all these facts, it just cannot possibly be argued that a practical man would regard the source of income in respect of the interest as not being in Singapore." Secondly, the proposition implies that the disbursement of the loan is the determining factor, which is far too simplistic a test. If that had been his intention the detailed analysis of the cases would have been quite unnecessary.

The only thing one could "accuse" Thean J. of adopting is the practical hard matter of fact approach. Adopting this approach, he found that the material facts pointed to Singapore: the funds for the loan were in Singapore and disbursement was in Singapore currency

23 *Nathan, supra,* n.14 at p. 198; also see Soon Choo Hock, *supra,* n.4 p. 44.
24 *Lever, supra,* n. 13 at p. 9 cited by Turner, North and Gresson JJ. in *Philips, supra,* n. 12 at p. 453, p. 445 and pp. 439-440 respectively; and cited by Thean J. in *Chandos* at p. 675.
25 *Lever, supra,* n. 13 at p. 15. *Chandos* at p. 676D.
26 The learned judge's own words in *Chandos* p. 675F and his discussion of *Lever* at pp. 675 to 676.
27 *Chandos* at p. 676D.

and took place in Singapore. The approach therefore taken by Thean J. is to regard the facts as a practical man would arriving at the material facts which pointed to the source of interest; then to see where these facts pointed. The implication is a weighing out of these material facts to determine which country they highlight. In place of the connecting factors in private international law, the search is for the "material facts indicating the source of interest".

The third observation concerns section 33 of the Act. In the course of his judgment Thean J. did not refer to section 33 of the Act (as it then was prior to the recent amendment[28]) when he found the transaction which took place in Johore Bahru to be "too superficial and also artificial". Although there has been a detected increase in judicial disapproval of tax avoidance,[29] it would at first sight appear odd to utilise the determination of tax liability under the source concept as an anti-avoidance device when there is the anti-avoidance provision in section 33 of the Act. However, this is probably the result of the Comptroller not raising it in his argument since there is no mention of it in the judgment. There will always be an overlap between the determination of tax liability and tax avoidance. A tax avoidance scheme may fail on the grounds that the income has its source in Singapore because in the course of evaluating the facts the court has the right to look at the substance and not the form; this is justifiable on the practical man approach.[30]

Finally, some comment is necessary on the second ground of the decision — the application of the second limb of section 12(6)(b). Thean J. held that since the funds from the loan by Chandos were used in Singapore, in that the cheques were cleared in Singapore and transferred from the Delacom's account to the Nazly Pura account, the interest was deemed to be derived from Singapore. The assumption is made that the phrase "income derived from loans" refers to interest. It is precisely this phrase which gives rise to two interpretations first pointed out by counsel for Chandos in a paper at a conference.[31] The first interpretation is to treat "income derived from loans" as referring to basically the same items covered in section 12(6)(a), namely, interest, commissions, fees and the like. The focus would then be on the creditor and the income earned. The second interpretation would place the focus on the debtor's income *(e.g.,* profits from the use of the funds obtained under the loan); that the phrase "income derived from loans" refers to the income derived from the funds provided by the loans, where such funds are brought into or used in Singapore.[32] This would render section 12(6)(b) a specific charging section of the Act as contrasted the general charging section in section 10. However, it appears that no argument was raised before Thean J. on this point and that counsel for Chandos was being consistent with his conviction also mentioned in his paper that the second interpretation would not hold. This is to be regretted as the present interpretation leaves the ambit of

28 S. 7 of the Income Tax (Amendment) Act 1988 (No. 1 of 1988).
29 Soin, *Singapore Master Tax Guide 1987* para. 2004C.
30 Thean J. referred to dicta by Turner J. in *Philips, supra,* n. 12 and Rich J. in *Tariff Reinsurances Ltd.* v. *Commissioner of Taxes* (1938) 59 C.L.R. 194; see his discussion at pp. 670-1 *of Chandos.*
31 Andrew Ang, *supra,* n.2 at p. 388.
32 A slightly different phraseology from that coined by Soon Choo Hock in his article, *supra,* n.4 at p. 48.

section 12(6)(b) very wide and capable of extra-territoriality in its application. It is also regrettable since the same second interpretation was demonstrated to be justifable in another article.[33]

Thean J. also defined the word "use" in section 12(6)(b) widely as "to employ to any purpose". Such an interpretation is consistent with either of the two interpretations mentioned earlier with the rest of the section which refers to various forms of investment income.

Conclusion

This decision is significant as it is the first decision to delve into the concept of "source" and section 12(6) of the Act. It made clear the fact that the guidance from Australian and South African decisions is applicable. However, the decision has not really clarified the difficulties in this area of the law, particularly the determination of the source of interest income. The court did not single out one factor as the determinant for the source of interest income. If it had done so it would have made things clearer. As a result individuals planning their activities to avoid having Singapore as the source of income still have to tread carefully. The decision has failed to allay previous fears that section 12(6) could be interpreted widely, leading to the possibility of extra-territorial imposition of tax.[34] It was earlier postulated[35] prior to the decision that if section 12(6) was construed widely, a loan made by a bank in another country to a non-resident where the funds happen to be remitted to Singapore might be subject to tax under section 12(6)(b). The interpretation adopted by the court is capable of having that effect. In the light of this, one can only hope that the Comptroller will exercise restraint in applying the section.

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33 See Soon Choo Hock, *supra,* n.4 at pp. 48-9.
34 *Ibid,* at p. 48 and Andrew Ang, *supra,* n.2 at p. 388.
35 See Soon Choo Hock, *supra,* n.4 at p. 48.

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