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ONE "NOT" TOO MANY: THE TAX TREATMENT OF LOSSES IN THE ASCERTAINMENT OF CHARGEABLE INCOME

This article examines the definition and treatment of tax losses in the computation of income. In particular, it addresses the scope of two anti-avoidance provisions aimed at counteracting schemes that exploit accumulated tax losses in companies. Among other things, it highlights the need for legislative reform to deal with the ineffectiveness and flaws in these provisions.

I. INTRODUCTION

THIS is not a survey of the principles that govern the ascertainment of chargeable income under the Singapore Income Tax Act.[1] It is confined to an analysis of the provisions governing the tax treatment of losses incurred in a trade, business, profession or vocation.[2] For the purposes of income tax, the computation of income arising from a trade, business, profession or vocation is, subject to principles of tax law, largely determined by ordinary principles of commercial accountancy.[3] A major source of such tax laws can be found in Part IV of the ITA.[4] The provisions in Part IV contain conditions and restrictions on the making of revenue deductions and capital allowances in the ascertainment of income. Any deduction of revenue or capital expenditure that has been made according to accounting principles must be added back to the balance of gain or profit if it is prohibited by the ITA. The final amount of income ascertained according to these principles is defined as the "full amount of income" from a trade, business,

[1] Cap 134, 1994 Rev Ed, as amended by Act No 11 of 1994 and the Income Tax (Amendment) Act 1995, Act No 32 of 1995, (hereinafter referred to as ITA). Unless otherwise stated, all references to section numbers in this article relate to the ITA.

[2] These provisions are found in Part VI of the ITA: ss 37, 37A and 37B.

[3] *Gallagher* v *Jones* (Inspector of Taxes) [1993] STC 537 at 544.

[4] Part IV of the ITA contains the following provisions: ss 14 to 24. In addition, the courts have created other tax principles such as the rule that a gain or profit cannot be anticipated and the treatment of stock in trade disposed otherwise than in the course of trade. See *Willingale* v *International Commercial Bank* [1978] 1 All ER 754 and *Sharkey* v *Wernher* 36 TC 275.

profession or vocation. Together with any other sources of income, they constitute the "statutory income" of the person entitled to them.[5]

From the statutory income, the ITA permits certain deductions to be made to obtain the "assessable income".[6] The deductions permitted are losses and approved donations.[7] The ITA provides for further deductions to be made from the assessable income to obtain the "chargeable income". The deductions allowed are essentially personal reliefs for qualifying individuals.[8] Finally, income tax is charged and payable on the chargeable income at rates specified in the ITA.[9]

II. What is a Loss?

Since income tax is a tax on income rather than receipts, it is necessary to ascertain the balance of receipts and expenses in respect of each source of income.[10] In determining this balance, only revenue receipts and revenue expenses are taken into account; all receipts and expenses on capital account are disregarded.[11] A profit is produced when the receipts of a source of income exceed the deductible expenses laid out to produce those receipts. Conversely, a loss is incurred when the deductible expenses laid out exceed the receipts. Therefore, a loss in respect of a source of income is essentially the excess of deductible expenses over receipts that is unrelieved.[12]

It is important to distinguish a loss under the ITA from a financial loss in ordinary commercial parlance. Financial losses may arise from trading or non-trading transactions. For instance, financial losses may result from debts that have turned bad or doubtful, embezzlement by employees, theft,

5 "Statutory income" is defined in s 35(1) as the "full amount of his income ... from each source ...." It includes any gain or profit deemed to be income but excludes income exempt from tax. For *eg*, see ss 10(1A), 10(4), 10C, 13 and 13A to 13H.

6 See s 37 and Part VI of the ITA.

7 Approved donations are approved gifts to an approved museum, gifts of money to an institution of a public character and any gift of a computer to a prescribed educational or research institution in Singapore: s 37(2)(b) to (d).

8 See ss 39, 40, 40B and 40C.

9 See ss 40, 40B, 40C, 42, 43, 43A to 43L and the Second Schedule.

10 *London County Council* v *AG* (1901) AC 26 at 35.

11 "The question of what is capital and what is revenue is a question of law for the courts": *per* Lord Denning MR, *Heather* v *P-E Consulting Group Ltd* [1973] 1 All ER 8 at 13. See also *Jeffs (Inspector of Taxes)* v *Ringtons Ltd* [1985] STC 809 at 822-3. However, certain capital expenses qualify for capital allowances: ss 16-24.

12 Unlike unrelieved capital allowances, no provision is necessary for the carry forward of unrelieved revenue deductions since they are carried forward from year to year as losses under s 37. On the other hand, unrelieved capital allowances granted for qualifying capital expenditure do not result in losses since they are not deductions under s 14. Thus, provision has to be made for the right to carry forward any unrelieved capital allowances: s 23.

robbery or the negligence of employees. However, it is misleading to regard these financial losses as losses in the context of the ITA since any adjustments that may arise from such financial losses are dealt with under section 14.

The ITA grants a deduction for a financial loss arising from a debt that has turned bad or doubtful. Under the accrual basis, a trading receipt equal to the amount of the debt would have been recognised at the time the debt was created.[13] When such a debt subsequently turns bad or doubtful, the ITA eliminates the trading receipt that had been taken into account by granting a corresponding deduction. Similarly, financial losses suffered as a result of embezzlement, theft, robbery or having to compensate third parties for the negligence of employees, are treated as "outgoings" within the ambit of section 14. The deductibility of such outgoings depends on whether they are so closely connected with the trade or business in question to constitute a cost of producing the income.[14]

III. When does a Loss Qualify for Relief?

The ITA provides relief for a loss by way of a deduction from the statutory income of a person. To qualify for a deduction, a loss must satisfy all the conditions laid out in section 37(2)(a). Section 37(2)(a) reads:

> "(2) There shall be deducted –
>
> (a) the amount of a loss incurred by that person during any year preceding the year of assessment in any trade, business, profession or vocation which, if it had been a profit would have been assessable under this Act ..."

It restricts a deductible loss to one that has been incurred in a trade, business, profession or vocation. Although the precise scope of the words "would have assessable if it had been a profit" is unclear, it may be interpreted to mean that a deductible loss shall be ascertained and computed in the same manner as a gain or profit. On that assumption, several conclusions may be drawn. First, a loss incurred with respect to a source of income outside Singapore would not qualify for deduction against any income

[13] See ss 14(1)(d) and 14I (in relation to banks).

[14] See *Curtis* v *J & G Oldfield* (1925) 94 LJKB 655, *Port Elizabeth Electric Tramway Co Ltd* v *CIR* 8 SATC 13; *Cf Bamford* v *ATA Advertising Ltd* [1972] 3 All ER 535, *Strong* v *Woodifield* [1906] AC 448. The position in Australia is different: *Charles Moore & Co Pty Ltd* v *FCT* (1956) 95 CLR 344. The statutes are not in *pari materia*: see *Andermatt Investments Pte Ltd* v *CIT* (Judgment of Chao J dated 12 August 1995 in CA 163 of 1994).

chargeable with tax in Singapore.[15] Income from such a source would not be assessable unless it is brought into Singapore.[16] Second, a loss incurred in relation to a source of income that is exempt from tax would also not qualify for relief unless the ITA provides otherwise.[17] Third, losses may not be anticipated.[18] Finally, losses on capital account are excluded.[19]

Where a loss qualifies for deduction under section 37(2)(a), it should be set off, as far as possible, against "... income of the first year of assessment after the year in which such loss was incurred ...."[20] Where there is no income from any other source or the amount of the loss exceeds the total income from other sources in the same year of assessment, the full amount of that loss or the excess thereof may be carried forward to be deducted against any income from the following or subsequent years of assessment. There is no time limit within which the loss must be utilised. Neither is the person entitled to the loss relief required to continue with the trade, business, profession or vocation in which the loss was incurred.

It should be noted that ITA imposes two specific limitations on the right to deduct a loss under section 37(2)(a). The first relates to a person who is granted a tax exemption or concession under any provision of the ITA. In such cases, the right to deduct a loss may be expressly limited to certain classes of income.[21] Alternatively, the manner or extent to which a deduction is to be allowed may be subject to regulations made under the ITA[22] or the discretion of the Comptroller.[23] In addition, the ITA provides special rules for the treatment of losses in cases where a company has certain income taxed at a concessionary rate and other income taxed at the normal corporate rate.[24] With effect from the year of assessment 1994, it permits such a company to deduct a loss incurred in a source taxed at one rate against income taxed at the other rate. Since the financial value of a loss

15 The position would be different if Singapore were to employ the world-wide basis of taxation. This is illustrated by the case of *Hock Heng Co Sdn Bhd* v *DGIR* [1979] 2 MLJ 51 when Malaysia used the world-wide basis of taxation.

16 See ss 10(1) and 10(13).

17 See ss 13A(3)(b), 13F(4) and 13H(5).

18 See *Willingale* v *International Commercial Bank*, *supra*, note 4.

19 Recently, the Court of Appeal held that there is no relief for capital losses: *CIT* v *GE Pacific Pte Ltd* [1994] 2 SLR 690 at 693.

20 *Proviso* to s 37(2)(a). The taxpayer is not entitled to elect for part of a loss to be carried forward if it can be fully set off in any year of assessment.

21 See s 43I(3).

22 See ss 10A, 10B, 26(3B)(b), 43A, 43D(1), 43E(1), 43F(1), 43G(1), 43H(1), 43J(1) and 43K(1).

23 See ss10D(2)(a)(ii) and 26(3B)(a).

24 S 37B. See also s 26(3B)(c).

from a source of income is a derivative of the applicable tax rate, a simple dollar-for-dollar deduction would not be appropriate.[25] Therefore, the ITA requires an adjustment to be made to the relevant income or loss for the purpose of effecting a deduction.

The other limitation is essentially an anti-avoidance measure. In the case of a company, the right to deduct a loss incurred in a trade or business (hereinafter referred to as the "loss company") is subject to sections 37(5) and 37A. The purpose of these two sections is to impose limitations on the two common means of deriving tax advantages by dealing with or through a loss company. The scope of these sections is discussed in some detail below.

IV. What is the Basis for the Right to Deduct or Carry Forward Losses?

Apart from commercial and financial mismanagement, the most obvious cause of a loss is the imposition of income tax by reference to an artificial basis period of one year. In reality, the activities of a trade or business are carried out on a continuous cycle. Depending on the nature of the trade or business, all or part of the deductible expenses incurred in a given year may not yield any chargeable receipt[26] or may not do so until several years later.[27] Where a taxpayer engages in such a trade, it is hardly surprising that unallowed deductible expenses may end up being artificially reflected as losses in certain years when the activities of the taxpayer are viewed on an annual basis. On the other hand, the receipts will appear as profits in other years.

Therefore, the right to carry forward a loss from one year to another is founded upon a necessity to counteract one of the undesirable con-

[25] All things being equal, an amount of loss incurred in a trade the income from which is taxed at a concessionary rate is certainly worth less than a similar amount with respect to a trade subject to tax at the normal corporate rate. If a taxpayer were permitted to deduct, dollar-for-dollar, a loss incurred in the source taxed at a concessionary rate against income from the source taxed at normal rate, a double benefit would result.

[26] Subject to s 15, revenue expenses are deductible under s 14 provided they were "wholly and exclusively incurred ... *in the production of income*" chargeable with tax. (Emphasis is mine) A deduction cannot be denied simply because an otherwise deductible expense fails to yield any chargeable receipt or identifiable chargeable receipt. An exception can be found in s 10E. It provides that: "Notwithstanding any other provisions of the Act, ... any outgoings or expenses incurred by the company ... which do not produce any income shall not be allowed as a deduction under section 14 ..." [S 10E(1)(a)].

[27] For *eg*, the trade conducted in *Vallambrosa Rubber Co Ltd* v *Farmer (Surveyor of Taxes)* 5 TC 529.

sequences of imposing income tax on annual basis periods. The ITA does not make special provision for averaging the income from a trade or business subject to inevitable fluctuations in its income from year to year. Nevertheless, the right to carry forward a loss has the effect of achieving, to a certain degree, an averaging of income from each source over the years subsequent to the year in which the loss was incurred.[28] The ITA does not grant a right to carry back losses to any year preceding the year of assessment in which the loss was incurred.[29]

In certain circumstances, the absence of a right to carry back a loss may exacerbate the financial hardship in the year in which a loss was first incurred. Besides the burden of having to finance the loss, a taxpayer may be required to pay income taxes imposed in that year in respect of chargeable income earned in the preceding year. On the one hand, it may appear difficult to justify confining loss relief only to income arising in the years subsequent to that in which the losses were incurred. On the other hand, it is submitted that a right to deduct losses against income from preceding years may increase the uncertainty of revenue forecast, provide opportunities for tax avoidance and create some administrative difficulties.

Finally, where a taxpayer has more than one source of income, any loss from one source may be set off against the income from another in the same year of assessment. The basis for this right is analogous to that in respect of the right to carry forward a loss from one year to another. Once the amount of gain from each source has been ascertained, the rationale for maintaining the strict classification of each type of income according to its source for the purpose of imposing tax ceases to be valid. A taxpayer with multiple sources of income should only be obliged to account for income tax by reference to any net profit arising from all the sources in a given year of assessment.

[28] Subject to the conditions imposed by the ITA, unrelieved losses may be carried forward indefinitely. These conditions are discussed in the paragraphs below. When income tax was first introduced through Ordinance No 39 of 1947, the right to carry forward losses was limited to a period of six years after the year in which the losses were incurred. The six-year limitation was abolished by Ordinance No 34 of 1954. In 1969, s 37(2) was extensively amended to take its present form.

[29] This may be contrasted with the position in the United Kingdom. Unrelieved losses may be carried back by one year. Start-up and terminal losses may be carried back by up to three years. See ss 380(1)(b), 381(1) and 388(1) of the United Kingdom Income and Corporation Taxes Act 1988 ("UK ICTA") as amended by the Finance Act of 1994. However, the Inland Revenue Authority of Singapore grants an administrative concession to property development companies. Certain development expenses incurred after the "TOP year" may be carried back to the "TOP year" under certain circumstances: see IRAS Interpretation and Practice Note No 11, *Compass*, (1993) Vol 1, No 3.

V. Restrictions on the Right to Deduct or Carry Forward a Loss by a Company

As pointed above, the ITA imposes restrictions on the deduction of losses incurred by a loss company. The rationale for the imposition of the restrictions is to counteract any tax benefits that may be obtained by utilising the accumulated losses in the loss companies. These restrictions are found in sections 37(5) and 37A. Section 37(5) is concerned with what is commonly known as "raiding of loss companies by profitable companies". Such losses are only deductible provided that the Comptroller is satisfied that there was no substantial change in the shareholders of the loss company. Section 37A seeks to deny the deduction of losses in circumstances known as "dividend stripping".

A. *Raiders of Loss Companies*

(i) *Restriction under section 37(5)*

Section 37(5) reads:

> Notwithstanding anything in subsection (2), the amount of any loss incurred by a company in any trade or business shall be disregarded unless the Comptroller is satisfied that the shareholders of the company on the last day of the year in which the loss was incurred were substantially the same as the shareholders of the company on the first day of the year of assessment in which such loss would otherwise be deductible under subsection (2).[30]

The section limits the right to deduct or carry forward a loss incurred by a company in the conduct of a trade or business. A loss shall not qualify for relief unless the Comptroller is satisfied[31] that the shareholders of the loss company were substantially the same on both dates, *ie,* on the last day of the year in which the loss was incurred and the first day of the year of assessment in which such loss would otherwise be deductible. (Hereinafter referred to as the "substantial shareholding requirement")

[30] S 37(5) was introduced by s 8(d) of the Income Tax (Amendment) Act 1969, Act No 23 of 69. A similar restriction was also introduced in relation to the right to carry forward excess capital allowances by a company: s 23(2).

[31] For a discussion of the law governing the exercise and control of administrative discretion, see Wade & Forsyth, *Administrative Law* (7th ed, 1994), at Chs 11 & 12 and Craig, *Administrative Law* (3rd ed, 1994), at Ch 8.

Where the substantial shareholding requirement is breached, the loss shall be disregarded and shall not be allowed as a deduction in any subsequent year of assessment.[32] For the purpose of the section, it is clear that the substantial shareholding requirement is determined only by reference to the two dates. As such, it is submitted that an "unbroken continuity" need not be maintained throughout the period between those two dates.[33]

The legislative intent of section 37(5) is to prevent a profitable company from "raiding" a loss company. In a typical "raid", a profitable company would secure the control of a loss company by acquiring an appropriate number of its shares. Upon achieving the requisite control, the profitable company would transfer to the loss company an income-generating asset or business. The income generated by that asset or business would be set off against the accumulated losses in the loss company. The financial benefit that would accrue to the profitable company from such a "raid" would be the amount of income tax relieved by the deductions arising from the accumulated losses in the loss company.

(ii) *Determination of substantial shareholding requirement: section 37(7)*

(a) *Section 37(7)(a)*

In determining whether the substantial shareholding requirement is complied with on both those dates, section 37(7)(a) provides that:

> the shareholders of a company at any date *shall not be deemed to be substantially the same* as the shareholders at any other date *unless*, on both those dates, not less than 50% of the paid-up capital of the company was held by or on behalf of the same persons, *nor unless*, on both those dates, not less than 50% of the nominal value of the allotted shares in the company were held by or on behalf of the same persons ... (Emphasis is mine)

The substantial shareholding requirement is formulated as a negative statement. As a general rule, the substantial shareholding requirement is

[32] S 37(6). This is rather harsh. A restriction similar to that in s 37A(1) may be adequate. See discussion at "B Dividend Stripping" below.

[33] See Australian position in *Kolotex Hosiery (Aust) Pty Ltd* v *FCT* (1973) 4 ATR 24. Mason J (as he then was) held that there was no need for an unbroken continuity of beneficial ownership under s 80A(1) of the Australian Income Tax Assessment Act 1936, Reprint No 9 ("Australian ITAA"). S 80A(1) of the Australian ITAA requires the beneficial ownership to be complied with "at all times" during each of the years of income and during the year of loss.

deemed NOT to be satisfied UNLESS not less than 50% of the paid-up capital of the company was held by or on behalf of the same persons, NOR UNLESS, not less than 50% of the nominal value of the allotted shares in the company was held by or on behalf of the same persons. Using symbolic terms, the substantial shareholding requirement may be expressed as: "Not S unless X, nor unless, Y."[34] The use of the negative conjunction "nor" in this context means that the exception is only made out if, on those two dates, both "X" and "Y" are satisfied. It is difficult to appreciate the need to frame the exception in such a complicated manner.

Two more points may be raised. First, it should be noted that the substantial shareholding requirement is concerned with the identity of the shareholders rather than the shares. There is no breach if a substantial change in the shareholding takes place among the same persons.[35] Second, the effectiveness of section 37(7)(a) has been doubted. A commentator has pointed out that "... neither the paid up capital nor the nominal value of shares necessarily determines the rights of the shareholders ... [since voting rights] ... can be varied by the company's memorandum and articles of association."[36] It is submitted that such variations are not possible in the case of a public company or its subsidiary. Each preference share (that carries a right to vote) or each equity share is entitled to one vote, and one vote only.[37] In all other cases, any special step taken to vary the voting rights in any class of shares for this purpose may well fall within the ambit of the anti-avoidance provision in the ITA.[38]

(b) *Section 37(7)(b)*

Where the shares in any loss company are held by shareholders through one or more companies, section 37(7)(b) lays down a tracing principle for determining the ultimate ownership of the shares in the loss company. It provides that "shares in *a company* held by or on behalf of another company shall be deemed to be held by the shareholders of the last-mentioned company ...."[39] Section 37(7)(b) is a general formula for the purpose of

[34] Where "S" means that the substantial shareholding requirement is deemed to be satisfied; "X" means that not less than 50% of the paid-up capital of the company was held by or on behalf of the same persons; and "Y" means not less than 50% of the nominal value of the allotted shares in the company was held by or on behalf of the same persons.

[35] *Cf* the position in Australia. See Lehman & Coleman, *Taxation Law in Australia* (3rd ed, 1994) at para 6.72.

[36] See Soon, "Tax Treatment of Trade and Business Losses" [1987] 2 MLJ ccxxxv at ccxlii.

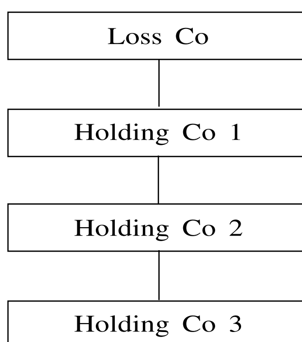
[37] S 64 of the Companies Act, Cap 50, 1994 Rev Ed.

[38] S 33.

[39] S 37(7)(b) also provides that "... shares held by or on behalf of the trustee of the estate of a deceased shareholder or by or on behalf of the person entitled to those shares as

ascertaining the actual ownership of shares in a loss company where they are held by or on behalf of another company. Thus, the substantial shareholding requirement cannot be circumvented by acquiring the shares of a holding company instead of the shares of the loss company it controls. This is because a change in the ownership of shares in the holding company is deemed to be a corresponding change in the shareholding of the subsidiary.

It has been pointed out that the tracing formula in section 37(7)(b) is limited to "the second stage of ownership".[40] The significance of this interpretation is that tracing would be ineffective if a substantial number of shares in a loss company were held by or on behalf of shareholders through multiple intermediary companies. This is illustrated in the example below. Section 37(5) would be inoperative if the control of the loss company were secured through the purchase of a suitable number of shares in Holding Co 3. No tracing would be permitted beyond Holding Co 2.



It is submitted that the interpretation would have been correct if section 37(7)(b) had read: "shares in a *loss company* held by or on behalf of another company shall be deemed ...."[41] It should be noted that the formula has been deliberately framed without any specific reference to a loss company. As such, the tracing formula may be applied to as many companies and as many times as may be required to discover the ultimate shareholders of a loss company in any corporate shareholding structure.[42] Thus, in the

beneficiaries under the will or any intestacy of a deceased shareholder shall be deemed to be held by that deceased shareholder."

40 See Soon, *supra*, note 36, at ccxli. See also CCH Tax Editors, *Singapore Master Tax Guide Manual* (Loose-leaf), at para 209.

41 Parliament subsequently introduced a slightly different tracing formula in another context: s 37A(4)(b). *Cf* the formulation in s 37A(4)(b) where tracing is expressly and directly tied to the "loss company": *infra*, note 67.

42 See also Pok, *Singapore Taxation* (2nd ed, 1989), at 188.

same example, shares in Holding Co 2 are deemed to be held by the shareholders of Holding Co 3.

(c) One "NOT" too many: section 37(7)(a) – a futile attempt

The purpose of enacting section 37(7)(a) is to ensure that changes to the beneficial ownership of shares are also taken into account in determining whether the substantial shareholding requirement is satisfied. This can be ascertained from the speech made by the Parliamentary Secretary to the Minister for Finance when he moved the motion that the Bill containing this provision be read a second time. He said that the section "... is aimed at restricting the carry-forward of losses to such cases where the beneficial shareholders to whom the carry-forward of losses is to be allowed are substantially the same as those in the company which incurred the losses."[43]

Unfortunately, section 37(7)(a) fails to achieve the statutory object or purpose. As pointed out in the preceding paragraphs, the substantial shareholding requirement is not regarded as satisfied unless not less than 50% of the paid-up capital and not less than 50% of the nominal value of the shares[44] were held by or on behalf of the same persons on both dates. Thus, section 37(7)(a) exhaustively spells out the only two situations in which the substantial shareholding is considered satisfied. They are (1) if not less than 50% of the shares was held by the same persons and (2) if not less than 50% of the shares was held on behalf of the same persons.

In framing the requirement "held on behalf of the same persons" as an alternative to "held by the same persons", the section presupposes that the control of a loss company can be secured only through a legal transfer of shares. It is submitted that the control of a loss company may be exercised without a legal transfer of the shares in question.[45] As such, the beneficial ownership in not less than 50% of the shares need not remain vested in the same persons to satisfy the substantial shareholding requirement if no legal transfer of the shares takes place. Since the maintenance of the

[43] *Singapore Parliamentary Debates Official Report*, Vol 29, 1969-70 at Col 268. A statement to the same effect can be found in the Explanatory Statement to the Income Tax (Amendment) Bill, No 18/69: "Before a loss can be carried forward it must be shown that the beneficial shareholders of a company ... were substantially the same ...." In this regard, it is submitted that the specific reference to "a Minister" in s 9A(3)(c) of the Interpretation Act, Cap 1, 1985 Rev Ed, in relation to the speech made during the Second Reading is unfortunate. Nevertheless, reference to the Parliamentary Secretary's speech may be justified under s 9A(2) and (3)(d) of that Act.

[44] For ease of reference, this dual requirement shall be referred to as "not less than 50% of the shares".

[45] The effective control of a company is often exercised through shareholders' agreements or nominees.

requisite beneficial ownership is an alternative to the maintenance of the requisite legal ownership, the restriction imposed in its current form may be ineffective.[46]

For instance, existing shareholders with not less than 50% of the shares in a loss company may agree to hold their shares on behalf of the person who intends to "raid" the loss company. Under such an arrangement, the substantial shareholding requirement is satisfied since these shares are still held by the same persons. This is in spite of the fact that the beneficial ownership in not less than 50% of the shares has been transferred to different persons.[47]

Therefore, in certain circumstances, section 37(5) may be ineffective in preventing a claim for loss relief. This is caused by the choice of sentence structure in section 37(7)(a). It has one "not" too many. Section 37(7)(a) may be amended in a number of ways.[48] One of them requires both "not"s to be deleted. Two negatives do not always a positive make. Alternatively, the substantial shareholding requirement in section 37(7)(a) may be framed with one "not" or two "not"s depending on whether the conjunction "if" or "unless" is used together with the words "same persons" or "different persons". These will result in four alternative formulations:

(1) "... shall be deemed to be substantially the same ... unless, on both dates, less than 50% of its paid-up capital or the nominal value of its allotted shares was held by or on behalf of the same persons."

(2) "... shall be deemed to be substantially the same ... unless, on both dates, not less than 50% of its paid-up capital or the nominal value of its allotted shares was held by or on behalf of different persons."

(3) "... shall not be deemed to be substantially the same ... if, on both dates, less than 50% of its paid-up capital or the nominal

[46] See *Wood Preservation Ltd* v *Prior* 45 TC 112 for a discussion on the implications of a conditional sale of shares.

[47] In the light of s 9A(1) of the Interpretation Act, Cap 1, 1985 Rev Ed, such a result ought to be avoided since it defeats the purpose of the provision. See *Tan Boon Yong* v *Comptroller of Income Tax* [1993] 2 SLR 48, *Raffles City Pte Ltd* v *Attorney General* [1993] 3 SLR 580, *Comptroller of Income Tax* v *GE Pacific Pte Ltd* [1994] 2 SLR 690 and *Chen Hsin Hsiong* v *Guardian Royal Exchange Assurance Plc* [1994] 2 SLR 92. See also Beckman & Phang, "*Beyond Pepper* v *Hart*: The Legislative Reform of Statutory Interpretation in Singapore" [1994] Vol 15 No 2 Stat LR 69.

[48] With a view to effect the least alteration to the language of the subsection.

value of its allotted shares was held by or on behalf of the same persons."

(4) "... shall not be deemed to be substantially the same ... if, on both dates, not less than 50% of its paid-up capital or the nominal value of its allotted shares was held by or on behalf of different persons."[49]

Apart from this problem, it is submitted that the restriction employed in section 37(7) is sound.[50] However, under the proposed amendment, an issue may arise if existing shareholders who own at least 50% of the shares in a loss company decide to transfer the legal title of their shares to trustees to be held on their behalf. Such a transfer would not constitute a breach of the substantial shareholding requirement under the current section 37(7)(a) since at least 50% of the shares are still held on behalf of the same persons. It would not be the case if any one of the proposed amendments were to be adopted. It is arguable that the proposed amendments would penalise shareholders unnecessarily and unfairly if the trust arrangement was entered into for sound commercial reasons and not for tax avoidance. Nevertheless, it is submitted that the solution to such an issue should be regulated by section 37(8).

(iii) *Exemption from the application of section 37(5): section 37(8)*

The Comptroller may exempt any loss company from the operation of section 37(5) if he is of the view that any substantial change in its shareholding was not effected for the purposes of tax avoidance: section 37(8).[51] This provision was introduced on the basis that "... existing legislation ... may unintentionally penalise companies whose restructuring is beyond their control."[52] Section 37(8) provides that:

[49] The Inland Revenue Authority of Singapore has reached a similar conclusion based on the current s 37(7)(a). The IRAS Interpretation and Practice Note No 8 states that the substantial shareholding requirement is not satisfied "... if more than 50% of the paid-up capital or nominal value of the allotted shares was held ... by different persons ...": see *Compass*, (1993) Vol 1, No 2, at para 2.

[50] See s 80A of the Australian ITAA for a different test.

[51] S 37(8) was introduced from the Year of Assessment 1988 by s 14 of the Income Tax (Amendment) Act 1989, Act No 3 of 1989. A similar provision in relation to capital allowances was also enacted by s 13 of that amendment: s 23(2A). Ss 23(2A) and 37(8) have been amended by ss 10 and 11 of Act No 11 of 1994 respectively. Pursuant to that amendment, the Minister has appointed the Comptroller of Income Tax to approve applications for exemption: *supra*, note 49, at para 5.

[52] Speech made by the Minister for Finance on the Second Reading of the Income Tax

> The Minister or such other person as he may appoint may, where there is a substantial change in the shareholders of a company and he is satisfied that such change is not for the purpose of deriving any tax benefit or obtaining any tax advantage, exempt that company from the provisions of subsection (5); and upon such exemption the loss referred to in subsection (2) (a) incurred by that company may be deducted but only against profits from the same trade or business in respect of which that loss was incurred.

The Inland Revenue Authority of Singapore has pointed out several instances in which the Comptroller is likely to grant the exemption. They are nationalisation, privatisation of a government-owned enterprise, changes in shareholding brought about by normal trading on the stock exchanges and the implementation of corporate rescue initiatives.[53] Besides these instances, it is submitted that there is least one other situation that may merit an exemption. Substantial changes in share ownership, whether in loss companies or profitable companies, do occur in the ordinary conduct of business. Sometimes, a substantial change in the ownership of shares in a loss company may not be accompanied by any change in the trade or business carried on by the loss company.[54] For instance, a loss company may be just one of the several companies belonging to a group of companies being acquired by an unrelated person. The mere fact that a substantial number of shares in a loss company have been transfered to different persons alone does not justify the denial of any loss relief. The purpose of section 37(5) is to deny any tax advantage that may accrue to any company from the transfer of a profitable source of income to a loss company. No tax consequences arise from the takeover of substantial shares in a loss company by the profitable company. The takeover of shares is merely the means to facilitate the transfer of a profitable source of income to the loss company.

Apart from these cases, there may be others that may not be easy to determine in advance whether they ought to qualify for an exemption. In such cases, the Comptroller is likely to evaluate each case according to its merits. An example of such a case is the creation of trust or nominee arrangements by existing shareholders mentioned in one of the paragraphs above. While it is arguable that uncertainty might result from such arrangements being left to be resolved by section 37(8), it is submitted that this may be expedient to prevent a potential loss of revenue. The precise purpose and effect of complex trust instruments or shareholder agreements that may

(Amendment) Bill, No 1 of 89: *Singapore Parliamentary Debates Official Report*, Vol 52, Jan-Feb 1989, at Col 569.

53 S*upra*, note 49, at para 6.

54 See s 80E of the Australian ITAA. That section permits a deduction of losses if the "continuity of business" test is satisfied notwithstanding a breach of the "continuity of ownership" test.

be created to govern the exercise of powers conferred by shares in a company may sometimes be difficult to determine. It may, thus, be more appropriate to leave it to the persons involved in any such arrangement to tender relevant information to satisfy the Comptroller that the arrangement qualifies for an exemption under section 37(8). The Comptroller would have the opportunity to distinguish between genuine trust arrangements entered into for commercial reasons from those that have been conceived to avoid tax. Given that such a distinction is desirable, it cannot be maintained under the terms of the current section 37(7)(a) since a transfer of legal ownership without affecting the beneficial ownership does not amount to a breach of the substantial shareholding requirement.

Finally, it should be noted that exemptions are granted by the Comptroller on the condition that the loss in question "may be deducted but only against profits from the same trade or business in respect of which that loss was incurred". The loss-making trade or business not only should not cease but that the same trade or business should be carried on for as long as may be required to generate some profit. No time limit is imposed. It is not immediately apparent why it is desirable or necessary to place upon every taxpayer who have been granted the exemption such an onerous burden. Futhermore, it is unfortunate that the condition is absolute rather than discretionary.

It is not doubted that the requirement to continue with the conduct of the same trade or business as a condition for exemption has its merits. To a certain extent, it advances the statutory objective of section 37(5). It discourages the proliferation of applications under section 37(8) for the sole purpose of preserving the loss relief. This reinforces the rationale that the relief from tax losses is limited to new shareholders who have genuine commercial and economic interests in the loss-making trade or business.

Nevertheless, it is submitted that the imposition of such an absolute condition is not without any problems. It ignores the fact that some corporate re-organisations effected for commercial reasons may involve or result in the immediate cessation of a loss-making trade or business. Moreover, the requirement of "*same* trade or business" creates some measure of uncertainty.[55] Difficulties are likely to occur when an existing trade expands, merges with another trade or business, or is discontinued in part or temporarily. On the one hand, it might be futile if it is interpreted too broadly. Yet a narrow interpretation may pose unwarranted obstacles to the implementation of changes that may be regarded as necessary to enhance the

[55] It is often a question of fact and degree. See *Gordon and Blair Ltd* v *IRC* 40 TC 358, *Tryka Ltd* v *Newall* 41 TC 146, *Seaman* v *Tucketts Ltd* 41 TC 422, *Ingram* v *Callaghan* 45 TC 151 and *Rolls-Royce Motors Ltd* v *Bamford* [1976] STC 162. See also s 385(1) of the UK ICTA and s 209(4) of the Finance Act [1994], *supra,* note 29.

viability or profitability of the loss-making trade or business.[56] Finally, it is difficult to appreciate the need for such a condition in cases where the Comptroller has been satisfied that the substantial change in the shareholders was not carried out for the purposes of tax avoidance.

Therefore, the imposition of an absolute condition may be incompatible and inconsistent with the object of section 37(8) if reliance on the Comptroller's discretion is regarded as the most efficient mechanism. The requirement of "same trade or business" is but one of several possible conditions that the Comptroller may see fit to impose in any given case.[57] A more meaningful scope in the discretion may be favourable to the development and maturity of the local equity market as well as the fund management industry. It may become more exposed to shareholding changes arising from shifts in capital movement in this competitive global capital market.

B. *Dividend Stripping*

Ten years after the introduction of section 37(5), Parliament had to amend the ITA again to counteract a different type of tax avoidance scheme. The situation had reversed. Section 37A was introduced to "plug the existing loophole in tax".[58] It was noted that "... companies with accumulated trading losses [were] acquiring the entire shareholdings of profit-making companies for the sole purpose of off-setting dividends declared by the acquired company against the accumulated trading losses of the 'loss' company."[59] Upon a successful acquisition, the loss company would utilise the loss relief by securing a huge dividend payout from the profit-making company to set off against its accumulated losses. As long as there is sufficient losses to deduct against the dividend income, the loss company would have no income tax liabilities.[60] This is commonly known as "dividend stripping".

56 S 80E(1)(b) of the Australian ITAA contains a similar requirement. The Australian experience also illustrates some of the difficulties in applying the requirement. For instance, the court in *Avondale Motors (Parts) Pty Ltd* v *FCT* (1971) 2 ATR 312 adopted a narrow interpretation while the case of *Hammond Investments Pty Ltd* v *FCT* (1977) 7 ATR 633 took a more liberal position.

57 This is the case with some of the sections enacted recently: ss 14J(3)(b) and 14K(2)(b). There are also many other similar examples in the Economic Expansion Incentives (Relief from Income Tax) Act, Cap 86, 1994 Rev Ed, as amended by the Economic Expansion Incentives (Relief from Income Tax) (Amendment) Act 1995 (No 1 of 1995): ss 14(9), 17(2), 19B(2), 19F(5) *etc*.

58 Speech made by the Minister for Finance on the Second Reading of the Income Tax (Amendment) Bill, No 9 of 1979: *Singapore Parliamentary Debates Official Report*, Vol 39, Mar-Nov 1979-80, at Col 301.

59 *Ibid*.

60 Under such circumstances, the tax credit provided by s 46 would result in an equivalent cash refund in favour of the loss company.

(i) *section 37A*

Section 37A was introduced with effect from the Year of Assessment 1980.[61] Section 37A(1) reads:

> Notwithstanding anything in this Act, in computing the assessable income of any company for any year of assessment, no deduction shall be allowed for any loss incurred by that company (referred to in this Act as the loss company) against any dividends received by it from an associated company:

Where section 37A applies, the loss will not be deductible against the dividends received from an associated company. Two comparisons may be made with section 37. Unlike section 37(5), it is rather surprising that section 37A(1) does not make any reference to section 37(2). Neither is it confined to a loss incurred in a trade or business. Second, the restriction in section 37A is narrowly cast. It merely prevents a loss company from deducting any loss against dividend income received from an associated company. The loss is not disregarded. It remains available as a deduction against any other income falling outside the scope of that description or the section itself.

While section 37A(1) could have been drafted more clearly, it is submitted that the words "any loss" in the context are only capable of describing a loss that comes within the terms of section 37(2)(a). After all, section 37(2)(a) is the only provision that permits a deduction for any loss in the computation of assessable income.[62] If this is the case, the specific reference to a "loss company"[63] in section 37A(1) is nothing more than any loss company similar to that dealt with by section 37(5).[64] However, it must be noted that section 37A(1) does not apply to any loss incurred by a loss company after the end of the accounting period during which the associated company paying the dividend first became an associated company of the loss company.[65]

(ii) *What is an associated company?*

[61] See s 10 of the Income Tax (Amendment) Act 1979, Act No 7 of 1979.

[62] This is the case despite the widely worded phrase "notwithstanding anything in this Act" in s 37A(1).

[63] This is the only section in the ITA that contains any reference to a "loss company".

[64] This interpretation is consistent with the contents of the speech made by the Minister during the Second Reading of the Bill: *supra*, note 58.

[65] Ss 37A(2)(a) and (3)(b).

Section 37A(3) defines the circumstances under which a company is deemed to be an associated company of a loss company. In the case of a private company, it is deemed to be an associated company of a loss company if "at least 25% of its issued capital is beneficially owned directly or indirectly by the loss company". It is 50% in the case of a public company.[66] For the purpose of determining the beneficial ownership of shares, the ITA permits tracing through multiple shareholding structures to the ultimate shareholders. The expression of the tracing formula in section 37A(4)(b) is rather elaborate.[67]

(iii) *When does the restriction in section 37A(1) not apply?*

There are three instances in which the restriction in section 37A(1) does not apply. The first is where the Comptroller is satisfied that "the object or one of the main objects of the declaration of dividends by the associated company to the loss company" is not to avoid tax.[68] Since the acquisition of shares in a company alone does not come within the scope of section 37A(1), it is reasonable to expect the loss company to satisfy the Comptroller that the declaration of dividends was not for the purposes of gaining a tax advantage.

Section 37A(1) is also inapplicable if the loss in question was incurred by the loss company after the end of the accounting period in which the associated company first became an associated company of the loss company.[69] The rationale is simple. It is not intended to prejudice the right of any company to deduct a loss simply because it is entitled to dividend income from an associated company. The section is only concerned with tax avoidance schemes that were entered into subsequent to the accumulation of losses by a loss company.

Finally, a deduction is available if the dividend from an associated company was paid out of profits that were earned after the end of the accounting period during which the associated company first became an associated company of the loss company: section 37A(2)(b). However, the deduction is not available if one or more associated companies are interposed between the loss company and the profitable company whose dividend the loss company seeks to set off against its losses.[70] This may be illustrated

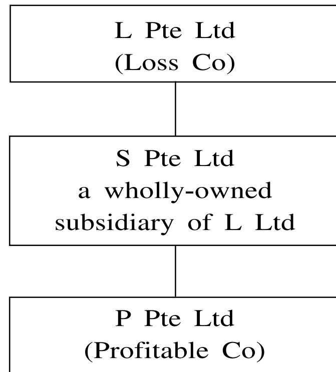
66 "Private" and "Public" companies have the same meanings as defined in s 4 Companies Act, Cap 50, 1994 Rev Ed.

67 Compared with s 37(7)(b), the formula employed here takes five times the length to achieve the same result, in a rather inelegant manner.

68 *Proviso* to s 37A(1).

69 S 37A(2)(a).

by the following diagram:



For the purposes of this illustration, it is assumed that L Pte Ltd intends to acquire more than 50% of the issued capital of P Pte Ltd. Since a direct acquisition by L Pte Ltd will certainly come within the prohibition in section 37A(1), L Pte Ltd proposes to structure the acquisition through S Pte Ltd. As a result of the acquisition, P Pte Ltd will become an associated company of L Pte Ltd.[71] Subsequent to the acquisition, S Pte Ltd will make a dividend distribution to L Pte Ltd out of profits derived from a dividend payout from P Pte Ltd. The objective of securing a dividend payout from P Pte Ltd would have been achieved. Yet section 37A(1) would be inapplicable. The dividend received by L Pte Ltd would have been regarded as paid by S Pte Ltd out of profits earned after S Pte Ltd first became an associated company of L Pte Ltd. A similar result would also be obtained if S Pte Ltd were the holding company of P Pte Ltd. In such a case, L Pte Ltd may proceed to acquire the issued capital of the holding company, S Pte Ltd.

It can be seen from this illustration that the restriction in section 37A(1) would have been ineffective if one or more companies were interposed between the loss company and the profitable company. Section 37A(3)(c) was enacted to counter such tax avoidance measures.[72] It provides that:

> any dividends received by the loss company from an associated company, being dividends which are paid by the associated company out of income representing, wholly or in part, dividends paid

[70] S 37A(3)(c).
[71] S 37A(4)(b).
[72] It has been suggested that s 37A(3)(c) is redundant: see Soon, *supra*, note 36, at ccxlv.

> by another associated company of the loss company to the first-mentioned associated company shall be deemed to be dividends received by the loss company from the second-mentioned associated company; and this provision shall apply notwithstanding any company or companies interposed between the first-mentioned associated company and the second-mentioned associated company.

Applying section 37A(3)(c) to the same example, the dividend received by L Pte Ltd from S Pte Ltd would be deemed to have been received from P Pte Ltd. Thus, section 37A(2)(b) would be inapplicable. However, section 37A(3)(c) deals only with any company or companies interposed between the loss company and the profitable company. The conclusion would be unclear if an unincorporated entity such as a trust or partnership were to be interposed between S Pte Ltd and P Pte Ltd. There are two main problems. One problem involves the question of whether P Pte Ltd would still be regarded as an associated company of the loss company. Section 37A(4)(b) provides that

> where a loss company beneficially owns *directly or indirectly* a fraction of the issued capital of a second company which in turn beneficially owns *directly or indirectly* a fraction of the issued capital of a third company, the loss company shall be deemed to have a beneficial ownership of the third company equal to such fraction as results from the multiplication of those two fractions; ... and so on. (Emphasis is mine)

While it is difficult to dispute that S Pte Ltd indirectly owns a fraction of the issued capital in P Pte Ltd, it is not clear whether the words "beneficially owned" includes the situation where S Pte Ltd is not a shareholder of P Pte Ltd. The extent of the problem would be exacerbated if the trust is discretionary and that S Pte Ltd merely holds a contingent interest.[73] The second problem relates to the scope of the phrase, "paid by the associated company out of income representing, wholly or in part, dividends paid by another associated company of the loss company", in section 37A(3)(c). Any dividend paid by S Pte Ltd would be regarded as derived from income out of a trust or partnership, whichever is the case, rather than dividends from P Pte Ltd. The words "income representing, wholly or in part" are apt to describe the quantum rather than the nature of the payment.

VI. Conclusion

[73] See Lehman & Coleman, *supra*, note 35, at para 6.73.

Currently, the general principles that govern the treatment of tax losses are products of piecemeal amendments to the ITA. Apart from section 37B, the provisions are essentially anti-avoidance measures. Despite the problems, section 37(7)(a) managed an unchallenged survival in the statute book for a quarter of a century! A re-examination of these rules is certainly overdue.

In addressing some of the specific problems, Parliament should take the opportunity to review the revenue policies in this area. So far the attention has been no more than a "sniper" approach in dealing with unacceptable tax avoidance schemes. Perhaps, Singapore should consider introducing group relief for losses in certain situations.[74] Where group relief for losses is available, a loss suffered by a member of a group of companies will be deductible against the income of the other members of that group. If any justification is needed for the introduction of such relief, it is submitted that, in certain circumstances, it is not only unnecessary but also artificial to treat members of a group of related companies as being separate legal entities. The legal fiction that a company is distinct from its shareholders is likely to become less significant in the future.

STEPHEN PHUA LYE HUAT*

[74] See s 80G of the Australian ITAA for a good example.

* LLB (NUS); LLM (Tax)(Lond); Lecturer, Faculty of Law, National University of Singapore; Advocate & Solicitor (Singapore).