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DEDUCTIBILITY OF EXPENSES UNDER SINGAPORE'S INCOME TAX ACT

Expenses incurred in the production of gross income would be deductible so that it would only be nett income which would be subject to income tax. Expenses, to be deductible, must satisfy certain statutory requirements under the Income Tax Act. This article examines the general principles of deductibility under the Act and identifies and addresses potential problems in the application of these statutory requirements.

I. INTRODUCTION

THE Singapore Income Tax Act[1] ('the Act') allows as deductions from gross income only expenses which satisfy sections 14 and 15 of the Income Tax Act. Deductible expenses would reduce income for tax purposes, so deductions are significant because they tend to reduce tax and hence increase profitability. This article explores the general conditions required for deductibility and highlights important issues which must be addressed when these general conditions are considered. It is hoped that this article would contribute to a better understanding of the deductibility regime under the Act.

This article will be organised into eight parts. The first part introduces the statutory framework of the deductibility provisions in the Income Tax Act. As there have been few local case law decisions on Singapore's deductibility provisions, the second part of this article will examine the applicability of foreign cases on similarly worded provisions in the second part. The general deductibility requirements will then be introduced and discussed in the subsequent four sections.

II. THE STATUTORY REGIME

There are two general deductibility provisions. They are found in sections 14 and 15 of the Act.

Section 14 reads as follows:

1 Cap 134, 1994 Rev Ed.

> 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, including:
>
> (a)
> .
> .
> (g)

Section 14(1) therefore allows for deductions which are 'wholly and exclusively incurred ... in the production of income.' In this article, the writer refers to this as the positive test of deductibility. Section 14 also lists, in subparagraphs (1)(a) to (g), a number of specifically allowable deductions which would, arguably, satisfy the above two requirements.

The second provision governing deductibility of expenses is section 15(1). It lays down a series of negative tests of deductibility which prescribes certain forms of expenses which are not deductible. Like section 14(1), there is a specific list of expenses in section 15(1)(a) – (k) but unlike section 14(1) (which allows for deductions) these expenses are expressly disallowed. It may be said that section 15 mirrors section 14 in that it provides negative requirements of deductibility. Section 15(1) begins with three negative requirements of very general application. Section 15(1)(a) – (c) are as follows:

> 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 –
>
> (a) domestic or private expenses except as provided by section 14(1)(f);
>
> (b) any disbursements or expenses not being money wholly and exclusively laid out or expended for the purpose of acquiring the income;
>
> (c) any capital withdrawn or any sum employed or intended to be employed as capital except as provided by section 14(1)(g);

The effect of the introductory words of section 15(1), "Notwithstanding the provisions" overrides all other provisions of the Act, including the positive test of deductibility in section 14(1). In determining whether an expense is deductible, one may therefore want to first consider if that expense falls within section 15(a) – (k). Only if the expense does not fall within section 15 should recourse then be made to section 14(1). While the subparagraphs of section 15(1) contain specific deductions expressly disallowed, subparagraphs (a), (b) and (c) need to be separately examined since they are of very wide application.

This is because the requirements in sections 14(1) and section 15(1)(a) – (c) are *generic*, and not as in the case of the other provisions of sections 14(1) and 15(1), *specific*. In general therefore, it may be said for an expense to be deductible:

1. The expense must *not* be

    a. a domestic or private expense (section 15(1)(a));

    b. an expense not wholly and exclusively laid out or expended for the purpose of acquiring the income (section 15(1)(b));

    c. capital withdrawn or a sum employed as capital (section 15(1)(c));

These are the three generic negative requirements which an expense must fulfill. Usually, the borderline cases would involve the question whether the expense was a capital expense or whether it was wholly and exclusively incurred for the purpose of acquiring income.

2. The expense must not be an expense falling within any of the specific classes of expenses in section 15(1)(d) – (k) where deductibility is expressly disallowed;

Examples of these expenses include sums recoverable under insurance contracts and payments for the use of private cars under certain circumstances. These classes of disallowed expenses are specific and, unlike (1) above will not normally have to be considered often.

3. The expense must:

    (a) be wholly and exclusively incurred in the production of income (section 14(1)); or

    (This is a generic requirement, the key issue to be satisfied is that the expense must produce income) or

(b) The expense must fall within section 14(1)(a) – (g).

(These are provisions which allow the deductibility of certain expenses even though, by themselves, the expenses may not fulfill necessarily section 14(1); *ie,* that they may not produce income.)

This article will focus only on the generic requirements listed in number 1 and number 3(a) above: domestic or private expenses, expenses wholly and exclusively incurred for the purpose of acquiring income; capital expenses, and expenses incurred to produce income. These requirements are most likely to be considered when the deductibility of expenses are at issue. However, before we examine these requirements in detail, we address the relevance of foreign case law.

III. The Applicability of Foreign Case Law

As there has been little local income tax case law authority on the ambit of sections 14(1) and 15, there is a tendency amongst tax practitioners to quote and rely on case law emanating from foreign jurisdictions, notably Malaysia, the United Kingdom, Australia, India, Hong Kong and South Africa.[2] There is also a tendency, with Singapore's British colonial heritage and with the passing of the Application of English Law Act[3] to refer in the first instance, to English tax cases to determine if a particular expense is deductible.

One should, however, rely on foreign case law sparingly. Revenue law is a creature of statute, and the Privy Council has warned that "... decisions on the words of one statute are seldom of value in deciding on different words in a different statute, and that different business transactions may give rise to different taxing results."[4] Decisions from foreign jurisdictions will therefore have to be treated with great caution and should not automatically be followed too closely. It may be better to rely on cases interpreting tax legislation which are word for word the same as the Act (as opposed to statutes which are simply *in pari materia*) than blindly follow UK cases based on differently worded statutes.

In Singapore, the High Court has ruled that as between English and Australian authorities, Australian authorities are to be preferred. In *ABC* v *CIT*,[5] Buttrose J, after referring to the quotation from the Privy Council

2 This observation can be made from a perusal of the Case Table to CCH Tax Editors, Singapore Master Tax Guide (14th ed, 1995), a leading local tax publication.

3 Cap 7A, 1994 Rev Ed. This Act expressly makes English common law part of the law of Singapore and also lists certain English statutes applicable to Singapore.

4 *Per* Lord Atkin in *Liquidator, Rhodesia Metals Ltd* v *CIT* [1940] AC 774.

5 (1959) 25 MLJ 162.

above, observed that the UK had a schedular system of taxation. Thus, each of the schedules in the UK's Income and Corporation Taxes Act 1988 ('the ICTA') formed a complete code in itself in respect of the tax which fell under it and that each code was distinct and complete in itself and was administered by different people. The Australian legislation therefore bore a closer relation to the Singapore provision. He concluded: "In my opinion therefore the English cases if not entirely inapplicable must be treated with considerable reserve."[6]

Perhaps this view is a bit too general. Concepts of 'income' and 'capital' are English common law concepts, so English decisions on these concepts would certainly be persuasive. But Buttrose J's view becomes pertinent when one compares the differences between the scheme for deductions in the UK and Singapore. There is no positive test of deductibility similar to section 14(1) under the ICTA. The UK scheme of deductions simply consists of express statutory prohibitions in section 74 of the ICTA. In this respect, section 74 is similar to the negative tests propounded in section 15. So if at all, cases decided under any of the subparagraphs of section 74 can only be persuasive authority insofar as the interpretation of section 15 is concerned. It has been said, in the context of the UK deductibility regime, that:

> The right to deduct expenses in computing taxable profit rests not on any express statutory provision but rather on the absence of any express prohibition; the right to deduct is inferred from the fact that it is the profit, not the receipts ... that are taxed.[7]

This difference can be explained by the underlying philosophy of the ICTA that whether a profit or gain was income for tax purposes fell to be determined in accordance with ordinary accounting principles. The UK system merely prohibits certain deductions. In Singapore, the position is different because sections 14 and 15 provide exhaustively for what may or may not be deducted. Unlike the UK, there are positive and negative tests of deductibility. This implies that ordinary accounting principles on whether an expense is deductible are not as relevant in the Singapore context as they would be in the UK context.[8] Australia's general deductibility provision appears to be closer to ours in that there is a general deductibility requirement (equivalent

6 *Ibid*, at 165.

7 J Tiley ed, *Butterworths UK Tax Guide 1994-95,* at para 7:96.

8 This appears to be the conclusion of the Privy Council in *CIR* v *Lo & Lo* [1984] 1 WLR 986 at 990-991, on ss 16 and 17 of Hong Kong's Inland Revenue Ordinance (LHK, 1981 rev, c 112), which are Hong Kong's deductibility provisions and which are *in pari materia* with our ss 14 and 15.

to the positive test of deductibility in our section 14) with a proviso comprising three generic negative requirements (which is the equivalent of our section 15).[9] Consequently, it may be said that in the interpretation of sections 14 and 15, Australian tax cases ought to be more persuasive.

However, this conclusion is not consistent with local authorities. In the Malaysian Federal Court case of *DGIR* v *Kulim Rubber Plantations Ltd.*[10] The Court was heavily influenced by foreign case law. It held that English and Australian case law are very persuasive in the interpretation of the phrase, 'wholly and exclusively incurred in the production of income' in the predecessor of our section 14(1). Chang Min Tat FJ, delivering the judgment of the court, stated that "The weight of judicial opinion seems to be against any finding that there is much material difference between the statutory provisions of [Australia, New Zealand and the UK]." However, as between Australian and English decisions, the Federal Court, felt that English cases were especially persuasive. The reasons for emphasizing the importance of English case law is succintly put by Chang FJ as follows:

> This court has laid down in *Khalid Panjang & Ors* v *PP (No 2)*[11] the principle that a Privy Council decision on appeal from another country is binding on it and the other courts of this country if the appeal is on a provision of law *in pari materia* with a provision of the local law. The decision in *Lasala* v *Lasala*[12] that the Privy Council would consider itself bound by a decision of the House of Lords must extend this principle to judgments of the House of Lords.

The conclusion therefore, is that House of Lords decisions on statutes *in pari materia* would be binding. The English House of Lords decision in

9 S 51(1) of the Australian Income Tax Assessment Act 1936 is as follows:

> *51(1) [Losses and outgoings]* 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.

It will be clear that an expense is deductible if the expense (a) is incurred in gaining or producing the income or (b) if necessarily incurred in carrying on a *business* for the purpose of gaining or producing income. Requirement (a) is the equivalent to our s 14(1). The proviso lists three situations where the expense is not deductible. This is where the expense is of a capital nature (*cf* our s 15(1)(c)); or of a private or domestic nature (*cf* our s 15(1)(a)) or related to producing exempt income.

10 [1981] 1 MLJ 214.

11 [1964] MLJ 108.

12 [1979] 2 All ER 1146 (PC).

British Insulated & Helsby Cables v *Atherton*[13] was thus relied on by the Federal Court.

This conclusion faces three objections. First, it ignores the rule of *stare decisis* that only decisions of courts within the same judicial hierarchy would be binding on lower courts. Secondly, the above reasoning can no longer be applicable because since that decision, appeals from Singapore and Malaysia no longer go to the Privy Council. Thirdly, and more importantly, it may be said that the court in *Kulim Rubber* was relying on cases decided on differently worded statutory provisions. The issue in the English and Australian cases mentioned in *Kulim Rubber* was whether the expense was of an income or capital nature and was decided on the equivalent of our section 15(1)(b). What was really at issue in that case was whether an expense was generally deductible under section 14(1) as expenses 'wholly and exclusively incurred ... in the production of income.' The court appeared to have skirted this issue and decided that the payment in question was a revenue payment and hence deductible.

The position on the applicability of foreign case law could therefore be as follows. The relevance of foreign case law on income tax will depend to a large extent on whether the foreign revenue statute on which the case law is based is *in pari materia* or identical to the local equivalent. On the question of deductibility of expenses, the UK's scheme of deduction (and indeed, the entire system of income taxation) is very different from ours. The UK does not have a general provision prescribing a positive test of deductibility. Australia, on the other hand does.[14] The Singapore High Court has held that as between the UK and Australian cases, UK cases should be treated with greater reserve. With these points in mind, we now turn to a discussion of the requirements of section 14 and section 15. We shall begin with the requirements of section 15.

IV. Section 15(1)(a): First Negative Requirement – The Expense Must Not Be a Domestic or Private Expense

The rationale for this requirement is the distinction between expenses incurred to produce income and expenses arising from the consumption of income. Only expenses incurred to produce income are deductible. Private or domestic expenses relating to the use of income already produced fall outside this category and are not deductible. In the words of Lord Greene in *Norman* v *Golder*,[15] such expenses "... [A]re laid out ... for the advantage and benefit of the taxpayer as a living human."

[13] [1926] AC 145.

[14] In s 51(1) of Australia's Income Tax Assessment Act 1936.

[15] (1944) 26 TC 293. The court also held that the expenses were not 'wholly and exclusively' incurred for the purpose of trade.

Norman v *Golder* is a good example where a private expense was disallowed. The taxpayer was a shorthand writer. He fell ill in the course of exercising this vocation.[16] He argued that his illness was the direct result of working in unfavourable conditions and therefore medical expenses incurred were deductible. The Court of Appeal unanimously held that the medical expenses were not deductible.

What exactly are 'domestic and private expenses'? In *CIR* v *Hickson*,[17] Beyers JA, delivering the judgment of the Appellate Division of the South African court, said, of these words; "Domestic and private expenses' are, I should say, without attempting an exhaustive definition, expenses pertaining to the household, and to the taxpayer's private life as opposed to his life as a trader."

One may make three observations here. First, the comments of Beyers JA were made in the context of the South African Act which expressly mentions rental and repair expenses of a 'dwelling house not occupied for the purposes of trade' as expenses falling within the term 'private or domestic expenses'. Hence the reference to household expenses. It may be that these comments may not apply to our local provision when our Act does not have an equivalent provision though it may equally be said that the word 'household' is within the definition of 'domestic' and 'private' in any case.

Secondly, the difference between 'private' as opposed to 'domestic' expenses. It may be said that the word, 'private' is of a larger import than 'domestic'; which would ordinarily relate to the household. This would mean that the word 'domestic' is a subset of 'private' and that 'domestic' is inserted in the statute by way of emphasis.[18] If this were the case, then the word 'domestic' would be superfluous. Yet, there is a presumption in statutory interpretation that Parliament must have intended some meaning to be attributed to the words of a statute.[19] So until clarification on this issue is given by the courts or legislature, the position is unclear.

[16] He had apparently caught a cold while taking shorthand notes for the Inland Revenue authorities – *Ibid,* at 300.

[17] (1960) 23 SATC 243 at 249.

[18] This is the view of Fayle & Gilders, 'General Commentary on s 51', in para 51/0325 of Vol 3, *Australian Income Tax Law and Practice*, Gzell *et al* (eds) looseleaf.

[19] This follows from the literal rule of statutory interpretation. Viscount Simon in *Hill* v *William Hill (Park Lane) Ltd* [1949] AC 530 at 546 said,

> When the legislature enacts a particular phrase in a statute the presumption is that it is saying something which has not been said immediately before. The rule that a meaning should, if possible, be given to every word in the statute implies that, unless there is good reason to the contrary, the words add something which has not been said immediately before.

Thirdly, it may be gathered, from this South African case, and from the facts of numerous other UK[20] and Australian authorities[21] on similarly worded provisions that this requirement would only apply to individuals. It may be said that companies do not have domestic or private expenses since it may be argued that every expenditure would be related to the business of the company.[22]

The main issue in the application of section 15(1)(a) is the distinction between a private expense and a business expense. The distinction can at times be very fine. Many business expenses confer private advantages which ought to be met by private expenditure. Take, for example, a situation where the medical expenses relate to some aspect of the human body vital to the carrying on of a business or profession. A concert or professional pianist injures his fingers and has to obtain expensive medical treatment for his fingers to enable him to continue his occupation. Would these medical expenses be deductible? There are a string of UK cases which forbid the deductibility of expenses relating to medical treatment.[23] They were based on the requirement that for an expense to be deductible, it had to be 'wholly and exclusively' incurred for the purpose of the profession and that the medical expenses on the facts did not have such a purpose. This corresponds with the second negative requirement. It should however, be noted at this juncture that Pennycuick J in *Prince* v *Mapp*[24] came very close to saying that some medical expenses could be incurred 'wholly and exclusively' for the *purpose* of the taxpayer's trade or profession. He said,

> It is quite easy to think of instances in which someone carrying on a trade or profession incurs some injury which is trivial in itself and in respect of which he would never otherwise expend money on medical care but which happens to be of vital importance for the purpose of that particular trade or profession. In such a case I am

[20] See, *eg*, *Norman* v *Golder*, (1944) 26 TC 293, *Murgatroyd* v *Evans-Jackson* (1967) 43 TC 581; *Prince* v *Mapp* (1969) 46 TC 169. The expenses in these cases were also disallowed on the basis that the expenses were not 'wholly and exclusively' expended for the purposes of trade, profession or vocation, a requirement found in s 74(a) of the ICTA. The local equivalent is s 15(1)(b), which is discussed *infra.*

[21] Among the leading cases in Australia are *Handley* v *FCT* (1981) 148 CLR 182; *FCT* v *Forsyth* (1981) 148 CLR 203; *FCT* v *Finn* (1961) 106 CLR 60; *FCT* v *Hatchett* (1971) 125 CLR 494; and *Lunney* v *FCT* (1958) 100 CLR 478.

[22] This would follow from the *dicta* of Lord Diplock in the Malaysian Privy Council case of *ALB* v *DGIR* (1950-1985) MSTC 33, who said that any gainful use to which a company puts any of its assets would *prima facie* amount to the carrying on of a business. It may be said therefore, that any expense incurred by a company would *prima facie* be a business expense.

[23] *Supra*, note 20.

[24] *Supra*, note 20, at 174.

> prepared to assume in favour of the taxpayer here that it would be possible for a taxpayer to incur expense which was wholly and exclusively for the purpose of his trade or profession.

In the local context, that an expense was wholly and exclusively incurred for the purpose of acquiring the income would only go to satisfying the second negative requirement in section 15(1)(b); for an expense to be deductible, it must still be shown that the expense was not a private or domestic one. The connection between sections 15(1)(a) and 15(1)(b) is therefore unclear.

Another troubling area relates to travelling expenses from home to work and *vice versa*. The personal element in this expense is the fact that the taxpayer would have to be travelling from home. If these travelling expenses were deductible, then the further the taxpayer's home is from his office, the larger the deduction that the taxpayer would be able to claim. So the quantum of deduction would therefore depend solely, on the taxpayer's personal (as opposed to a business) choice of choosing and living in a particular house. From this point of view, it may be said that the expense is a private or domestic one.

English cases have refused to allow deductions for travelling expenses, not on the ground that these expenses were private or domestic, but again on the ground that the expense was not wholly and exclusively incurred for the purposes of the trade or profession.[25] Yet, the sole purpose of incurring the expense of travelling to work is to earn income. There is no personal advantage apart from the fact that the expenses were incurred solely to earn income. In view of the above, it could still be said that the expense was wholly and exclusively incurred to produce income. It may therefore be just as appropriate to deny deductibility because the expense is a private or domestic one. It was on this basis that the Australian High court in *Lunney* v *COT*[26] by a 4-1 majority refused to allow a deduction for travelling expenses to and from work.

In that case, the Court addressed the argument that the expenditure would not have been incurred but for the fact that the taxpayer had to travel to his place of employment to earn the income. The majority of the Court (Williams, Kitto and Taylor JJ) said:

> ... to say that expenditure on fares is a prerequisite to the earning of a taxpayer's income is not to say that such expenditure is incurred in or in the course of gaining or producing his income. Whether or

[25] See, *eg*, *Newsom* v *Robertson* (1953) 1 Ch 7 (UK, CA), *Horton* v *Young* [1971] 3 All ER 412 (UK, CA). These cases were decided on the UK provision equivalent to our s 15(1)(b).

[26] (1957-58) 100 CLR 478.

> not it should be so characterised depends upon considerations which are concerned more with *the* essential character of the expenditure itself than with the fact that unless it is incurred an employee or a person pursuing a professional practice will not even begin to engage in those activities from which their respective incomes are derived.[27]

The majority were therefore concerned with the 'essential character' of the expenditure, a term which, it is submitted, is a difficult test to apply in many cases. How is one to determine the 'essential character' of an expenditure? In *Lunney*'s case, the essential character of the expenditure was that they were fares to bring the taxpayer to his place of work, where he earned income. The connection between the earning of income and the travelling expenses was not close. Thus it may be said that the expenditure was not incurred in the production of income, though it may equally be said that the distinction that it was a private expense and not a business expense is very fine. Also, the 4-1 majority judgement was by no means unequivocal: Dixon CJ, one of the judges in the majority, expressed the view that had the matter have to be decided afresh without prior precedent he may have ruled in favour of allowing a deduction.

What of entertainment expenses, which in many cases confer a very high degree of personal enjoyment? It has been argued that a business lunch confers three forms of benefit to a taxpayer who takes a client out for lunch – a necessity benefit (in that the taxpayer has to consume a lunch anyway); a pleasure benefit (in the sense of the pleasure obtained in taking a client out for a good meal) and a work benefit (in the sense that a lunch would generate some goodwill and promote the taxpayer's business).[28] To what extent are the expenses relating to business lunches domestic or private expenses so that they would be rendered non deductible by section 15(1)(a)?

Education expenses also pose a problem. The purpose of education would be, in a very broad sense, to develop one's appreciation of life. Expenses incurred to this end cannot therefore be considered business expenses in that they are incurred to produce income. However, further education equips the taxpayer for more challenging and higher income paying jobs. Take, for example, the education expenses of a taxpayer lawyer who at the request of his employer, pursues a part-time Master of Laws course at a University. The taxpayer could argue that this was not a domestic or private expense since it could enhance his career prospects in legal practice and promotion within the law firm. The argument for deductibility becomes stronger for

[27] *Ibid*, at 499.

[28] Kerridge "Deductibility of Expenses for Schedule D Income Tax – The 'All or Nothing' Rule", [1986] BTR 36 at 47, discussing the case of *Bentleys, Stokes and Lowless* v *Beeson* (1952) 33 TC 491.

a lecturer who pursues a PhD at his own expense on the basis that promotional prospects in the University would be brighter upon completion of the course.[29] One approach to the issue would be to rule that education expenses would not be private or domestic expenses where the course undertaken is relevant to the taxpayer's employment or business. In a situation where the employer expressly indicates as part of the contract of employment, that a particular educational qualification would be necessary for career advancement, or industry requires, as part of the process of upgrading the taxpayer's skills, that a particular course be taken by the taxpayer, then there is good reason to rule that the expense incurred would not be a private or domestic expense.

Section 39(2)(h) clarifies the position somewhat. It provides for an allowable deduction of up to $2000 for course fees and tuition relating to the taking of an approved course of study which is related to the taxpayer's trade, business, profession, vocation or employment. However, it also provides that expenses allowed under section 14 would not be allowed under section 39(2)(h). But it is difficult to see how an education expense can be deductible given the presence of a provision like section 39(2)(h). Since section 39(2)(h) exists, an education expense claim under section 14 can only arise where the expense is not related to the taxpayer's trade, business, profession, vocation or employment; in which case the education expense would be a domestic or private expense. Perhaps what can be done, in respect of entertainment and medical expenses, is to have similar statutory provisions to clear up the uncertainty.

In summary, the application of the first negative requirement in section 15(1)(a) is still uncertain. The courts have yet to be presented with an opportunity to come up with an elucidation of the term, 'private or domestic expenses'. This has resulted in difficult issues arising in borderline cases. But this state of affairs can perhaps be explained on the basis that practically every private or domestic expense will have a business connection. The expenditure on food, clothing and lodging is necessary to enable the taxpayer to be in a position to earn income. One needs to be dressed decently, eat and sleep and have a home in order to earn income. The UK cases have skirted the issue by ruling, under the equivalent of our section 15(1)(b), that these expenses are not 'wholly and exclusively incurred' for the purpose of the business. An Australian case, *Lunney* v *COT*[30] has, on the other hand,

[29] A similar argument was made in *CIR* v *Hatchett* (1971) 125 CLR 494. In this case, the taxpayer was a teacher who paid an amount of $89 in connexion with the submission of theses for the purpose of gaining a Teacher's Higher Certificate. This certificate would enable the taxpayer to command a higher salary for doing the same work and to progress beyond a certain salary ceiling. It was also a necessary qualification in some schools. The Australian High Court held that such an expenditure was not of a private nature and hence deductible.

[30] *Supra*, note 26.

suggested that the 'essential character' of the expenditure be examined, but this presents problems of definition.

V. Section 15(1)(b): Second Negative Requirement – Expenses Wholly and Exclusively Incurred for the Purpose of Acquiring the Income.

This requirement centres on the purpose of the expense. The purpose of the expenditure must be to acquire income. The purpose must be a sole and exclusive purpose. The key words in section 15(1)(b) are 'wholly and exclusively...for the purpose of acquiring the income'. The UK counterpart is section 74(a).[31] There is no counterpart to section 15(1)(b) in Australian legislation. It would thus be instructive to examine English cases for guidance.

The leading English case on the interpretation of these words is *Bentley Stokes & Lowless* v *Beeson*.[32] In that case, the taxpayers were a firm of solicitors. They incurred expenses when they brought their clients out for lunches. They claimed a deduction for these expenses on the ground that they were wholly and exclusively incurred for the purposes of their profession. At first instance, the Commissioners held that the expenses could not be wholly divorced from the relationship of host and guest and therefore, could not be wholly and exclusively incurred for the purposes of the profession. The Court of Appeal approached the matter differently. Romer LJ, delivering the judgment of the Court of Appeal, said that the word 'wholly' referred to the quantum of the money expended and was not relevant to the case. This requirement would be satisfied if every cent of the expense must be incurred for a business purpose. But his comments on the word, 'exclusively' are interesting:

> The sole question [in this case] is whether the expenditure in question was exclusively laid out for business purposes, that is: What was the motive or object in the mind of the two individuals responsible for the activities in question ... The difficulty however arises, as we think, from the nature of the activity in question. Entertaining involves inevitably the characteristic of hospitality. Giving to charity or subscribing to a staff pension fund involves inevitably the object of

[31] S 74(a) is as follows: 'Any disbursements or expenses not being money wholly and exclusively laid out or expended for the purposes of the trade, profession or vocation'. Under our s 15(1)(b) the purpose of the expenditure must be to acquire income, which is slightly different – see *Whiteman on Income Tax*, (3rd ed, 1988), para 7-13. However, the discussion in this article will focus on the words, 'wholly and exclusively' which relates to the extent of the purpose required.

[32] *Supra*, note 28.

> benefaction. An undertaking to guarantee to a limited amount a national exhibition involves inevitably supporting that exhibition and the purposes for which it has been organised. But the question in all such cases is: was the entertaining, the charitable subscription, the guarantee, undertaken *solely* for the purposes of business, that is, solely with the object of promoting the business or its profit earning capacity?[33] (emphasis added)

To satisfy the 'exclusively' requirement would be difficult. If there was more than one purpose behind the expenditure, then the expense would not be 'exclusively' incurred for the purpose of acquiring income and hence not be deductible. It would not be difficult to find more than one purpose in any given situation when expenditure is incurred. An example was given by Lord Brightman in the leading case of *Mallalieu* v *Drummond*:[34]

> A medical consultant has a friend in the South of France who is also his patient. He flies to the South of France for a week, staying in the home of his friend and attending professionally on him. He seeks to recover the cost of his air fare.

His Lordship held that in this example, the cost of flying to France would not be deductible because the journey was not undertaken solely to serve the purposes of the doctor's medical practice, but to visit his friend as well and have a holiday on the French Riviera.

The facts of *Mallalieu* v *Drummond* further highlight the 'exclusively' requirement. The taxpayer, a lady barrister, was required, under court rules, to wear dark suits and shoes and white blouse when attending court proceedings. She sought to deduct the costs of replacement, cleaning and laundering of her court clothes on the basis that they were her working clothes and the expenditure to maintain them was incurred 'wholly and exclusively' for the purposes of her profession. The House of Lords, in a 4-1 majority judgment, held that the expenses were not wholly and exclusively incurred for the purposes of her profession. The expenditure suffered from a duality of purpose. The second purpose for the expenditure was the provision of clothing that the taxpayer needed as a human being. The clothing was required for the purposes of warmth and decency, she needed it to travel to work and wear at work. This finding was inescapable. This was so in spite of the fact that the taxpayer chose only those clothes for the purposes of court attendance and only chose to wear those clothes to work when she had to attend court.

[33] *Supra*, note 28, at 503-504.
[34] [1983] 2 All ER 1095.

Two comments on this decision may be made. The first comment relates to the scope of the rule. Lord Brightman, who delivered the majority judgment, conceded that it was a matter of degree. There were cases where "it [would be] essential that the self-employed person should provide himself with and maintain a particular design of clothing in order to obtain any engagements at all in the business that he conducts." His Lordship admitted that these cases are matters of "fact and degree".[35] In these more extreme situations, the law would allow a deduction. Following from his Lordship's comments, the following approach could be taken. If, because of the constraints of the taxpayer's occupation, he has to be specially attired such that his clothes cannot be bought 'off the rack' in departmental or other public stores, then there is a stronger case for deductibility.[36] On the other hand, where the work clothing is easily available in departmental stores, and can and would normally be worn as ordinary clothing on social or other occasions, then it may be more difficult to claim that the cost of replacement and laundering would be wholly and exclusively incurred in the production of income. The test would be whether a particular set of clothing is easily available and can be purchased 'off the rack' and worn outside the particular working environment. This, it should again be noted, is a question of fact and degree.

The second comment relates to the application of the rule. There is difficulty in applying the rule because the purpose of an expenditure may not be clear-cut in many cases. Deductions are permissible only if the expense is incurred with the *sole* purpose of producing income. Expenditure incurred for more than one purpose would not be deductible. This point was made earlier on. Furthermore, the difficulty of ascertaining the purpose has been exacerbated somewhat by this decision since Lord Brightman rejected the approach that the relevant purpose was not the conscious motive of the taxpayer when she incurred the expenditure. Determining the relevant purpose required a more objective (as opposed to subjective) approach – Lord Brightman held that the provision of clothing was an "inescapable object" of the expenditure. What is the distinction between an objective and subjective approach? In the former, the question would be whether the expense would, in the mind of a reasonable man, have been incurred for the purpose of acquiring income. If the test were subjective, then the question whether the expense would have been incurred for the purpose of acquiring income would depend on the state of mind of the *particular* taxpayer concerned – the question would then be whether the taxpayer, in the position

[35] *Ibid*, at 1103.

[36] *Quare* whether regular Singapore Armed Forces personnel who purchase army equipment in stores open to the public would be able to claim a deduction in respect of this expenditure.

that he was, would have felt that the incurring of the expense would have had that purpose of producing income.

In this regard it should be noted that the object in the mind of a business person behind the making of a particular expenditure may be different from that of a reasonable man. A business person may feel that a particular expenditure in particular circumstances would be rightly incurred for acquiring income but a reasonable man may not feel the same way. An astute taxpayer in a particular business may have different views on the incurring of expenditure from an objective, reasonable man. It is submitted that the correct approach is somewhere in between, there should be some element of subjectivity in determining whether the purpose is one of acquiring income or not. It is felt, therefore, that the courts should not rule out business considerations in the incurring of expenditure – the test of purpose should not be purely objective.

There is yet a third difficulty. Lord Brightman also distinguished between purpose and effect:

> The object of the taxpayer in making the expenditure must be distinguished from the effect of the expenditure. An expenditure may be made exclusively to serve the purposes of the business, but it may have a private advantage. The existence of that private advantage does not necessarily preclude the exclusivity of the business purposes.[37]

It was at this juncture in his judgment that his Lordship alluded to his illustration of the medical consultant who flew to the French Rivieria. If the sole *purpose* of flying to France was to attend to his patient, then it would not matter if the *effect* of doing so conferred a private advantage to the medical consultant – holidaying on the Riviera. If, however, staying on the Riviera was a second or secondary purpose (the first being to attend to his patient) then it cannot be said that the expense was 'wholly and exclusively' incurred for the purpose of acquiring the income. But the distinction between purpose and effect is very fine. Take the facts in the *Bentleys* case. The purpose of the solicitor in taking his client for lunch is to promote the business of the firm. It would not matter if one effect was that the solicitor received a private benefit in that he would not have had to spend money on a lunch meal for himself.

Lord Brightman's distinction would pose some difficulty for the Income Tax Board of Review (the Board), which, as a fact finding tribunal, is saddled with the task of determining the purpose of an expenditure for the purposes of section 15(1)(b). It may be that even in very ordinary, everyday situations,

[37] *Supra*, note 34, at 1100.

the Board would have problems determining if a particular result is achieved because of the purpose of the expenditure or was simply an effect of that expenditure. This is because very often, the effect of an expenditure would have an influence on its purpose. The awareness of a particular expenditure having a particular private advantage may 'taint' the purpose. It would be obvious to the solicitor that taking a client out for lunch would, in effect, mean a free lunch for himself. In such situations, it may not be entirely free from doubt that the only purpose for buying the client lunch was to produce income for the firm.[38]

It would not be diffficult to justify the finding that the effect of a particular expenditure is in reality another separate purpose that expenditure, distinct from the purpose of acquiring income. For example, to modify the facts slightly in the *Bentleys* case, suppose the client was the brother-in-law of the solicitor; or a friend of the solicitor; or became a friend of the solicitor. Would then the sole purpose of the lunch be to generate goodwill and hence business for the solicitors' firm? What if the client was an old school friend and the solicitor decided to take the client to lunch for 'old times sake' and this generated some work for the firm? It cannot in all certainty be said that the purpose of the client lunch was solely to generate income for the firm. The nature of the activity concerned – a client lunch would suggest hospitality and entertainment. It cannot in all certainty be said that the expenses for lunch were incurred solely for the purpose of producing income. Consequently, in this second situation where the client was already a friend of the solicitor and that the lunch was not incurred solely for the business purposes of generating income for the firm, the requirement that the expense be exclusively incurred for the purpose of earning the income would disallow the deduction since there was a private purpose for taking the client to lunch.

From the above, it is possible to say that the 'wholly and exclusively' requirement would work injustice in many situations. Most business expenses are incurred with mixed purposes. The rule would exclude any expense which had a non-work related motive. This could be too drastic. A fairer and more realistic approach would be to apportion expenses with more than one purpose. If, therefore, the expense could be distinctly separated and dissected then part of the expense which 'wholly and exclusively' related to the acquisition of income would be deductible and part of the expense

[38] Kerridge, *supra,* note 28, thought that it was possible to find three different forms of benefit to a solicitor who takes a client out for lunch – a work benefit (goodwill engendered may result in more work for the firm), a pleasure benefit (enjoyment of good food and company) and a necessity benefit (the solicitor has to eat lunch in any case). Notwithstanding *Bentley*'s case, it would be difficult for the solicitor to argue that his sole purpose in taking the clients out to lunch was to generate goodwill for the law firm. Generating goodwill though, may not necessarily result in the client introducing more work

relating to the private purpose would not be allowed a deduction. However, unlike the Australian equivalent,[39] section 15(1)(b) does not expressly allow for apportionment.[40] So in Singapore if there were two or more purposes for the expenditure and one purpose was a private one, the expenditure would not be deductible since the expenditure was not *exclusively* incurred for the purpose of acquiring the income. It would therefore, be up to the taxpayer to argue that on the facts an apportionment was possible, and that the right to apportion expenses is implied.

One final observation on this requirement. It may be said that any expenditure disallowed because they did not fulfill the 'wholly and exclusively' requirement would usually be of a private or domestic nature and accordingly would in any case be disallowed under section 15(1)(a). It may be observed that the difference between section 15(1)(a) and section 15(1)(b) is that section 15(1)(a) forbids expenses of a particular nature - domestic or private expenses; and this depends very much on the courts' objective perceptions of an expense. The question in section 15(1)(a) is whether the expense is, according to societal perceptions, a domestic/private expense or an expense which produced income. The approach taken under section 15(1)(a) would tend to be objective. Section 15(1)(b) on the other hand requires an examination of the taxpayer's purpose in incurring the expenditure. There is scope here for the taxpayer to argue that his subjective purposes be taken into account in determining if the expenditure be disallowed.

VI. Section 15(1)(c): Third Negative Requirement – The Expense Must Not Be of a Capital Nature

Section 15(1)(c) expressly disallows the deductibility of capital withdrawn or sums employed as capital in the production of income. Arguably, a provision like section 15(1)(c) is not even necessary given that the distinction between an income and a capital gain is at the heart of income tax law. The Act only subjects to tax gains of an income nature. In determining

to the firm.

39 The phrase, 'to the extent to which' in s 51(1) suggests that an apportionment is permissible under the Australian statute. The leading decision in Australia on the apportionment of expenses is *Ronpibon Tin NL* v *FCT* (1949) 78 CLR 47.

40 While the UK provision is similarly worded, it would appear that the UK revenue authorities are prepared to allow for apportionment. See J Tiley ed, *supra,* note 7, at para 7:99. The courts are similarly inclined as well. In *Ransom* v *Higgs* [1974] 1 WLR 1594 at 1604, Lord Reid said,

> It seems to me that [s 74(a)] could well be read as meaning that if it can be shown that a part of the expenditure was in fact wholly and exclusively for trading purposes,

net income gains only income expenses may be deductible. Capital gains and expenses are consequently outside the income tax net, which is why capital expenses are not deductible.

But as in many other areas of revenue law, the principle is easier to state than apply. What is a capital and what is a revenue expense? How are they distinguished? In deciding the question, the courts had originally appeared to be looking for factors/indicia which determine whether the payment is capital or income.[41] This led Dixon J in 1946 in *Hallstrom Property Ltd* v *FCT*[42] to observe, of the approach of the courts in determining whether a payment is of an income or capital nature, that:

> The courts have proceeded with the task without, it is true, any very conspicuous attempt at analysis, but rather in the traditional way of stating what positive factor or factors in each given case led to a decision assigning the expenditure to capital or to income as the case might be. It is one thing to say that the presence among the circumstances of a case of a particular factor places the case within a specific legal category. It is another thing to infer that the absence of the same factor from some other case necessarily places that case outside the category and gives it an opposite description. But towards that kind of fallacy human reasoning constantly tends, and the decisions upon matters of capital and income contain much reasoning that is quite human.

The result of this approach was that many judicial tests were pronounced to distinguish between a capital and income expense.[43] As a result of these tests, the application of which may in certain cases, contradict each other,

then that part is a proper deduction.

41 See, *eg*, Viscount Cave in *Atherton* v *British Insulated and Helsby Cables Ltd* [1926] AC 205 at 213, (the 'enduring benefit' test), Lord Dunedin in *Vallambrosa Rubber Co Ltd* v *Farmer* (the 'once and for all' test) and Dixon J in *Sun Newspapers Ltd and Associated Newspapers Ltd* v *FCT* (1938) 61 CLR 337 at 359-363, and Lord Wilberforce in *Tucker* v *Granada Motorway Services Ltd* [1979] STC 393 (the 'identifiable asset' test) which are the more commonly referred to tests distinguishing between the income and capital expenses. See generally the judgment of Lord Templeman in *Lawson* v *Johnson Matthey plc* [1992] STC 466 which described these tests and their application.

42 (1946) 72 CLR 634 at 646.

43 *Supra*, note 41.

44 See, *eg*, *Regent Oil Co Ltd* v *Strick* [1966] AC 295 and *BP Australia Ltd* v *COT* [1966] AC 224, decided on virtually indistinguishable facts by the same five Lords of Appeal on the same day but with different conclusions. Lord Pearce, delivering the judgment of the Privy Council in the latter case, said:

> The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a commonsense

ambiguity still exists at the borderline.[44] This led Lord Wilberforce in *Tucker* v *Granada Motorway Services* to sceptically comment as follows:

> It is common in cases which raise the question whether a payment is to be treated as a revenue or as a capital payment for indicia to point different ways. In the end the Courts can do little better than form an opinion which way the balance lies. There are a number of tests which have been stated in reported cases which it is useful to apply, but we have been warned more than once not to seek automatically to apply to one case words or formulae which have been found useful in another. (See *Comrs of Taxes* v *Nchanga Consolidated Copper Mines Ltd*) Nevertheless reported cases are the best tools that we have, even if they may sometimes be blunt instruments.[45]

It would follow that an approach which requires the courts to identify certain factors/indicia and conclude if the expenditure was a capital expenditure would often be unsatisfactory, even arbitrary. This result would not be surprising since the same kind of approach is applied to determine whether a trade is carried on[46] and the position whether in a given situation a taxpayer was trading is always a difficult question.

It seems clear, however, that the key is to identify the asset or advantage obtained as a result of the expenditure and analyse it in the context of the taxpayer's income producing operations.[47] Where the asset or advantage obtained yields a permanent benefit to the income producing operation, then

> appreciation of all the guiding features which must provide the ultimate answer.

For a commentary on the two cases, see Whiteman, "The Borderline between Capital and Income", in [1966] BTR 115.

45 [1979] STC 393 at 396. Lord Greene MR in *IRC* v *British Salmson Aero Engines Ltd* [1938] 2 KB 482 at 498 was rather pessimistic:

> There have been many cases that fall on the border-line. Indeed, in many cases it is almost true to say that the spin of a coin would decide the matter almost as satisfactorily as an attempt to find reasons.

Lord Pearce in *BP Australia Ltd* v *COT*, *ibid,* at 265 observed,

> As each new case comes to be argued felicitous phrases from earlier judgments are used in argument by one side and the other. But those phrases are not the deciding factor, nor are they of unlimited application. They merely crystallise particular factors which may incline the scale in a particular case after a balance of all the considerations has been taken.

46 See, *eg,* the most recent pronouncement by the Income Tax Board of Review on this question, *W Holdings Pte Ltd* v *CIT* (1992) 1 MSTC 5135 at 5150, where the Board applied the six 'badges of trade' test to the facts before them.

47 See the judgment of Lord Templeman in *Lawson* v *Johnson Matthey plc*, *supra*, note 41, where his Lordship analyses previously decided cases on capital expenditure. It is observed that all the cases his Lordship mentions indicate that the expenditure is almost always characterised as capital expenditure where it is related to the acquisition of an asset or right

there would be capital expenditure. Lord Templeman's judgment in *Lawson* v *Johnson Matthey plc*,[48] the most recent House of Lords' decision on the revenue/capital expenditure distinction, appears to have taken this approach in determining if capital expenditure was made.

In that case, the question was whether a payment made by a parent company to its subsidiary was a revenue payment and hence deductible. The subsidiary, Johnson Matthey Bankers Ltd ('JMB'), was in financial trouble and its collapse would involve the destruction of the business of its parent, the taxpayer company. The Bank of England was prepared to rescue JMB if the taxpayer company would inject £50 million into JMB and transfer the entire share capital of JMB to it for a nominal consideration of £1. This was carried out. The taxpayer sought to claim the £50 million payment as a deductible expense. The sole issue was whether this expense was of a revenue or capital nature. The Revenue won in the High Court and Court of Appeal but lost in the House of Lords. The House of Lords unanimously held that the payment was a revenue payment and hence deductible.

Lord Templeman and Lord Goff delivered the leading judgments. Lord Templeman adopted a traditional approach, examining the leading cases in this area. He commenced his review with the 'enduring benefit' test in the *dicta* of Viscount Cave in *Atherton* v *British Insulated and Helsby Cables Ltd*[49] and concluded with Lord Wilberforce's 'identifiable asset' test in *Tucker* v *Granada Motorway Services Ltd*.[50] In addressing the Revenue's argument that the £50 million payment was capital expenditure because it was paid by the taxpayer company to get rid of the worthless JMB shares to the Bank of England, he said:

> In the light of the authorities it seems that if the £50 million were paid to procure the transfer of the shares in JMB to the Bank of England, the payment is attributable to capital. If on the other hand, the £50 million were paid to remove the threat posed by the insolvency of JMB to the continuation in business of the taxpayer company, it seems that the payment is attributable to revenue ... the £50 million were paid, and paid solely to enable the taxpayer company to be able to continue in business ... the £50 million were not paid to persuade the Bank to take the shares. The £50 million were paid to persuade the Bank to rescue JMB.

This seems an uncomfortably arbitrary distinction. According to his Lord-

which yields a more permanent, non-transient advantage to the income earning operations.

[48] *Supra*, note 41.

[49] *Supra*, note 41.

ship, payment to effect the rescue would thus be a revenue expenditure. But looking at the facts from another point of view, it could also be said that the rescue of JMB could be an enduring advantage for the benefit of the taxpayer's business and hence expenditure to secure this benefit would be capital expenditure. In fact, a payment made to enable business to continue can often be said to be made for the enduring benefit of the business. Conclusions based on the way in which a legal issue is expressed often generate some uneasiness because of the uncertainty involved. But this would be a result of applying the traditional approach of examining the facts to determine if the relevant indicia are present or absent. The state of the law however, is such that courts are drawn to make such distinctions to justify their conclusions.[51]

A more significant comment may be made of Lord Templeman's judgment. As noted earlier on, the central question in Lord Templeman's review of the relevant authority was whether the expenditure was incurred for the bringing into existence an asset or advantage of a permanent form. Quite clearly, his Lordship had in mind the oft quoted *dicta* of Viscount Cave in *Atherton* v *British Insulated and Helsby Cables Ltd* which is as follows:

> When an expenditure is made not only once for all, but with a view to bringing into existence an asset or advantage for the enduring benefit of a trade, I think there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital.[52]

Two components of the *Atherton* test can be discerned. First, a payment made on a 'once and for all' basis and secondly, the requirement that the payment be made to acquire an asset for the enduring benefit of a trade. From his Lordship's review of the cases, it may be said that more emphasis was placed on whether there was an enduring benefit rather than whether the payment was made 'once and for all'. It would appear therefore, that it is not so important that the payment was made 'once and for all'[53] as whether the asset which was brought into existence was of some permanent benefit to the business. While this may give some direction to the traditional approach, one difficulty with this analysis is the meaning of the key concepts of 'enduring benefit' and 'asset or advantage'. Until a court pronounces that something is an *asset or advantage of enduring benefit* to a trade, one

[50] *Supra,* note 41.
[51] *Supra*, note 44.
[52] *Supra*, note 41.

will be left guessing whether a relevant expenditure is capital or revenue expenditure.

Lord Goff's judgment proceeded on a refreshingly different basis. Whilst he found the Revenue's arguments attractive, they did not accord with the "reality of the situation". The reality of situation could not be obtained by perusing the terms of the agreement between the taxpayer company and the Bank.[54] Rather, the reality was that "the payment cannot be described as money paid *for* the divestiture of the shares; it was rather a contribution to the rescue of JMB planned by the Bank, which was a prerequisite of the transfer of the shares in JMB to the Bank for a nominal consideration." Consequently, Lord Goff's judgment did not contain as detailed and as thorough an analysis of case law precedent on capital expenditure as Lord Templeman's. It may be said that Lord Goff's approach was less legalistic and precedent based.

After making the point that the reality of the situation was that the payment was for the rescue of JMB, Lord Goff downplayed the importance of the purpose of making the payment in determining whether the payment was a capital or income expense:

> [T]he payment does not become a revenue payment simply because the taxpayer company paid the money with the *purpose* of preserving its platinum trade from collapse ... The question is rather whether, on a true analysis of the transaction, the payment is to be *characterised* as a payment of a capital nature. That characterisation does not depend upon the motive or purpose of the taxpayer. Here, it depends upon the question whether the sum was paid for the disposal of a capital asset.

This seems clear enough. In the Singapore as well as the UK context, the purpose of payment would have been considered under section 15(1)(b) as separate requirement for deductibility. We have seen earlier on that the purpose of payment is highly relevant, but insofar as determining if the expenditure was 'wholly and exclusively expended for the purpose of acquiring

53 Viscount Cave in *Atherton* v *British Insulated and Helsby Cables Ltd*, *supra,* note 41.

54 *Supra*, note 41, at 474-475. Lord Goff's analysis seems to support the statement of Dixon J, in *Hallstroms Pty Ltd* v *FCT*, *supra*, note 42, at 648 who said,

> What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process.

This statement is quoted with approval by Lord Pearce in *BP Australia Ltd* v *COT*, *supra*, note 44, at 264. It could be said that in characterising the nature of the payment, more emphasis should be placed on practical and business realities than on the terms in legal

the income.' There would therefore, be no need to consider the purpose of the expense again.

Another observation on the above passage may be made. His Lordship did not indicate how a characterisation of the nature of the payment as income or capital would have to be made, preferring, instead, to view the matter on the basis of the reality of the situation. It is implicit that to characterise the payment, one should look at the practical and business point of view rather than legal documentation surrounding the circumstances in which the payment was made.[55] The approach would seem to be that legalistic, technical distinctions based on case law precedent should not be pressed too hard. Consequently, there is much to be said for the approach of Dixon J;[56] that the question whether a payment is capital or revenue would depend largely on the nature of the payment *vis-à-vis* the income earning operations of the taxpayer (and in this respect, the court would want to consider whether the payment is recurrent, whether it is larger than other payments made by the taxpayer in the course of producing income) and the advantage obtained by the payment (the court would have to consider whether the advantage is of a lasting quality, and how is it employed in the taxpayer's business).

Once the three negative requirements above are satisfied, the taxpayer will have to satisfy the positive test of deductibility, to which we now turn.

VII. Section 14(1): General Deductibility – The Expense Must Be Incurred in the Production of Income

Section 14(1) requires that all expenses be 'wholly and exclusively incurred ... in the production of the income'. The words, 'wholly and exclusively' have already been dealt with in the context of the second negative requirement and no further discussion is necessary here. The central theme in section 14(1) is found in the operative words, 'in the production of income'. The expense must produce income. But when would a business expense 'produce income'? In the South African decision of *Port Elizabeth Tramway Co Ltd* v *CIR*,[57] the court, examining a similarly worded provision in the South African Income Tax Act, felt that two issues had to be addressed:

(a) whether the act, to which the expenditure is attached, is performed in the production of income, and

(b) whether the expenditure is linked to it closely enough.

documents.

55 *Ibid.*

56 In *Sun Newspapers Ltd* v *FCT* (1938) 61 CLR 337 at 363.

Watermeyer AJP, in the *Port Elizabeth Electric Tramway Co Ltd* case, explained:

> ...[A]ll expenses attached to the performance of a business operation *bona fide* performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are *bona fide* incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.

Therefore, in order to determine whether an expense was incurred in the production of income, the act to which the expense is attached must be examined. That act must be closely connected to the earning of income. The focus is on the *quid pro quo* for which the expense is incurred. However, it may be said that the expenditure accompanying the act is not the only factor to bear in mind. How the act fits in with the rest of the income earning operations should also be considered. Take the case of a business enterprise. Many acts would have to be performed in the course of business. Some may not be necessary to produce income, or even related to income production. Some acts, while not necessary, may yet be *bona fide* performed to produce income. Yet other acts which may be performed in the production of income in respect of a particular business may not be productive of income in a different business context. In order therefore, to determine if the act is performed in the production of income, one would necessarily have to consider the nature of the taxpayer's business enterprise. The nature of the business enterprise is therefore, another important factor to be considered.

The next question, given that the act and the nature of the enterprise are factors to be considered, is how that connection between the act entailing the expense and the income generating enterprise of the taxpayer is to be measured.

One approach would be to examine the contractual advantage obtained as a result of the expenditure. In the New Zealand Privy Council decision of *IRC* v *Europa Oil (NZ) Ltd*,[58] Lord Wilberforce, discussing a provision which was *in pari materia* with section 14(1)(a), said,

> For a claim to disallow a portion of expenditure incurred in purchasing trading stock to succeed, the Crown, in their Lordships' judgment, must show that, as part of the contractual arrangement under which

[57] (1935) 8 SATC 13, Pok & Hong, Singapore Taxation, (2nd ed, 1989), at 97.

[58] [1971] AC 760 at 772. Lord Diplock in the second *Europa* case ([1976] 1 All ER 503) affirmed this approach of examining the legal rights acquired by the taxpayer as a result

> the stock was acquired, some advantage, not identifiable as, or related to the production of, assessable income, was gained, so that a part of the expenditure which can be segregated and quantified, ought to be considered as consideration given for the advantage. Taxation by end result, or by economic equivalence, is not what the section achieves. This test, the strictness of which their Lordships consider should be emphasised, can only be satisfied after a rigourous and objective examination of the contractual arrangements under which the expenditure is made.

Similarly, Lord Diplock in *Europa Oil (NZ) Ltd* v *IRC (No 2)*[59] said,

> Their Lordships...empha[sise] that it is not the economic results sought to be obtained by making the expenditure that is determinative of whether the expenditure is deductible or not; it is the legal rights enforceable by the taxpayer that he acquires in return for making it.

The approach seems to be as follows. The legal rights (and not the economic results) obtained as a consequence of the expenditure have to be examined. Expenses in acquiring legal rights not related to the production of income would therefore not be deductible. Only the expenses incurred in acquiring the legal rights relating to the production of income would be deductible.

The main criticism of this approach is that not all expenditure incurred in producing income would involve the obtaining of contractual advantages or rights.[60] Not all business expenditure (nor for that matter, not all expenditure) can be measured by legal rights and obligations acquired as a result of that expenditure. Many expenses are in fact based on expectations and goodwill. Advertising expenses, for example, do not involve a contractual *quid pro quo*, yet few would argue that these expenses are not incurred in the production of income. Expenses for business lunches would not be

of the expenditure.

59 *Ibid,* at 508.

60 This point was made by Brennan J in *Magna Alloys & Research Pty Ltd* v *FCT* (1981) 11 ATR 276 where his Honour very aptly put it thus:

> But there are cases where expenditure is not incurred solely to acquire an asset or legal right under a contract or to discharge a legal obligation, and there are cases where there is dispute as to the scope and nature of activities and operations by which assessable income is or is intended to be gained or produced, or by which a business is carried on. In cases of these kinds, the *Europa* approach does not give adequate guidance to a court in finding whether the expenditure is deductible...

Similarly, Lord Wilberforce, in his dissenting judgment in *Europa Oil (No 2), supra,* note 58 at 517 said,

> The words 'in the production of the assessable income' are wide words – wider than 'in order to obtain trading stock' and wider than 'in consideration of something which

deductible because the lunch expenses may not yield any advantage or right which would produce income. An approach based strictly on legal rights would therefore not be wide enough to encompass most situations.

A second approach would be to suggest that if the expense was incurred for the *direct purpose* of producing income, then it would be incurred in the production of income. This approach was taken in *Ward & Co Ltd* v *COT*,[61] a Privy Council decision from New Zealand. In that case, the relevant statute provided that no deduction was to be made in respect of expenditure 'not exclusively incurred in the production of the assessable income'. The Court held that this provision required that allowable expenditure must have been incurred 'for the direct purpose of earning profits'.[62] In *Ward*'s case, expenditure incurred by the taxpayer, a brewery company, in influencing public opinion against the prohibition of intoxicants was not allowed because the court held that it was not incurred in the production of the brewery company's profits. It seemed obvious that the expenditure would have ensured that the taxpayer remained profitable. Yet the court held that it was not deductible. Viscount Cave LC said,

> The expenditure in question was not necessary for the production of profit, nor was it in fact incurred for that purpose. It was a voluntary expense incurred with a view to influencing public opinion against taking a step which would have depreciated and partly destroyed the profit-bearing thing. The expense may have been wisely undertaken, and may properly find a place, either in the balance sheet or in the profit and loss account of the appellants; but this is not enough ... it must have been incurred for the direct purpose of producing profits.[63]

The direct purpose of the expenditure was to prevent/reduce losses and not to earn income. But often, the directness of purpose is simply a question of degree. Advertising expenses, which influence public opinion in the buying of the products of the taxpayer company, would be deductible since they would be incurred for the purpose of producing income, but not expenditure incurred to influence public opinion to allow the legal consumption of alcohol. A test based on the directness of purpose may therefore also lead to difficulties of arbitrariness.

It may be said that the Act supports a wide reading of the words, 'in

the other party agrees to provide.'

61 [1923] AC 145.

62 *Ibid*, at 150. See also the subsequent Privy Council decision of *CIR* v *Appuhamy* [1962] AC 127 at 133 where Viscount Radcliffe cited with approval the rule in *Ward*'s case.

63 *Ibid*, at 150-151.

64 Ss 14(5) – (8) caps an employer's deduction for medical expenses at 2% of the total

the production of income'. Sections 14(5) – (8) of the Act[64] assume that some medical expenses incurred by the employer for the benefit of the employee are deductible under section 14(1). Under sections 14(5) – (8), medical expenses of the employer of up to 2% of the employee's remuneration would have deemed to have been incurred in the production of income. Arguably, it may be said that there is no direct relation between the incurring of medical expenditure and the production of income of the employer. Also, the legal rights obtained by the employer as a result of the expenditure, (that a sick employee would be entitled to be treated) would not produce income. It may be said that medical expenditure, as envisaged by section 14(5), is very different from the paradigm situation where a trader incurs expenditure in the purchase of trading stock which is then sold for profit. In that situation, the relationship between the expenditure and the production of income is clearly direct. Yet, the Act assumes that medical expenditure incurred by the employer for the benefit of the employee is usually deductible. This would suggest a wider, broader, approach to the reading of the words, 'in the production of income'.

One wider approach could be as follows. It would be that it need not be necessary for the expenditure to be incurred for the direct purpose of producing income. An indirect purpose for the production of income would suffice. If the expenditure was incurred for a *bona fide* business purpose for producing income, then it would be a good reason to suggest that the expenditure is deductible.[65] If however, the expenditure were excessive (for example, $10,000 for a set of uniforms) or if it were illegal or prohibited (for example, expenditure incurred to bribe government officials to introduce government contracts to a law firm) then the expense would not be a *bona fide* business expense incurred in the production of income. There is, however, one major problem with this approach. It could be said that the Act already deals with purpose as a requirement under section 15(1)(b) (which was earlier commented upon) and there is therefore no further scope for considering purpose under section 14(1) which, while requiring that the expenditure produce income in order to be deductible, does not suggest that purpose is a relevant consideration. Purpose would already be a consideration under section 15(1)(b). How would another approach, based on the purpose of the expenditure, under section 14(1), be different or helpful? It could

remuneration of his employees.

65 In the discussion of this requirement, Watermeyer AJP in the *Port Elizabeth Electric Tramway* case thought that purpose was important. See *supra*, note 57, at 16 & 17.

66 As discussed earlier on in the context of s 15(1)(b), the word, 'wholly' refers to the quantum of the expenditure, while the word 'exclusively' refers to the fullness of the motive – the motive must be fully for business purposes. The quality of the purpose referred to in discussing whether an expense is incurred in the production of income would involve considering whether the expenditure had a reasonable commercial purpose, whether the

be argued that section 15(1)(b) only relates to the *extent* of the purpose and not the *type* of the purpose.[66] The words, 'wholly and exclusively ... for the purpose' in section 15(1)(b) go to the measure/extent of the purpose, whereas under section 14(1), the inquiry is whether there is a *bona fide* purpose behind the expenditure.

1. *Relationship with other subparagraphs of section 14*

An expense may satisfy one or more of the subparagraphs of section 14(1) but not satisfy the positive test of deductibility in section 14(1); *ie,* the expense may not 'wholly and exclusively incurred in the production of income'. Would the expense be deductible, if it fell within one of the subparagraphs of section 14 but did not satisfy section 14(1) itself?

One view is that the expense would be deductible if it fell within any one of the subparagraphs in section 14(1)(a) – (g), even if it did not satisfy section 14(1). This view is supported by the Singapore High Court case of *MNO* v *CIT*[67] which held that the word 'including' in section 14(1) is a term of extension and that the subparagraphs of section 14(1) are not exhaustive in the sense that it was not a complete code of deductions.[68] Hence, the deductibility provisions in subparagraphs (a) – (g) of section 14(1) need not satisfy the positive test of deductibility. In the *MNO* case, Buttrose J held that contributions made to the Central Provident Fund Board were deductible as they fell within the predecessor section of section 14(1)(e), notwithstanding that the contributions may not have satisfied the positive test of deductibility.

The second view is that the positive test of deductibility in section 14(1) should first be satisfied when an expense is sought to be deducted under

expenditure was negligently/carelessly incurred, whether the expenditure was prohibited or illegal. These factors, which have very important implications, do not come up when one considers the other three requirements; but may be relevant when one considers whether the expense produces income for the purposes of s 14(1).

[67] (1961) 27 MLJ 223.

[68] This view is consistent with the Privy Council decision of *CIR* v *Lo & Lo*, *supra*, note 8, at 991, where Lord Brightman, in discussing ss 16 and 17 (which are the Hong Kong equivalent of ss 14 and 15) of Hong Kong's Inland Revenue Ordinance (LHK 1981 Rev, c 112), said

> It is perfectly correct to say that sections 16 and 17 provide exhaustively for the deductions which are permissible to be made, but not in the sense that permitted deductions are confined to the particular matters specified in [the subparagraphs] of s 16.

[69] Interpretation and Practice Note 19 in *IRAS Compass*, Vol 3 No 2 published on 17 April 1995, at 4, discussing the application of s 14(1)(a). Para 2 of this note suggests that for the IRAS to allow a taxpayer's claim for deduction of interest expense, he must be satisfied, *inter alia*, that the expense satisfies general conditions listed in para 1. One of the general conditions of para 1 is that the expense must be wholly and exclusively incurred in the

any one of the subparagraphs in section 14(1). This view is taken by the Inland Revenue Authority of Singapore (IRAS).[69] The effect of this view is that the production requirement would always have to be satisfied before one can even proceed to claim a deduction under the specific deductibility provisions under section 14(1). Taking this view would mean that allowable deductions are only limited to those listed in the section 14(1). Such a conclusion seems rather narrow and may be inconsistent with the *MNO* case and the comments of Lord Brightman in *CIR* v *Lo & Lo*,[70] and section 39(1)(h) which assumes that education expenses, a category of expenses not mentioned in the subparagraphs of section 14(1), is deductible under section 14(1).

VIII. CONCLUSION

The statutory requirements represent an attempt to allow deductions which are within the income tax regime and which are closely connected with the income earned. They are extremely technical. Perhaps the best way to approach the question of deductibility is to ask whether it ought to be incurred from a reasonable business point of view. Commercial considerations should be taken into account. Lord Brightman, in the *Lo & Lo* case, said,

> In the opinion of their Lordships, commercial considerations are not wholly to be disregarded in the course of this process [of determining whether an expense is deductible or not]. They are relevant for the purpose of deciding what can properly be treated as 'outgoings and expenses ... incurred during the basis period ... in the production of profits in respect of which ...' the taxpayer is chargeable to tax.[71]

The better approach, where there is difficulty encountered in determining if a particular expense is deductible, is for the courts and the IRAS to consider the commercial considerations involved when the expenditure was incurred – the question should always be whether a reasonable commercial man have deemed the particular expense to be deductible as part of the process of earning income? If, in accordance with commercial considerations the expense ought to be deductible, then it is felt that the IRAS and the courts should, as far as possible, read the provisions of sections 14 and 15 in a manner to allow a deduction.

LIU HERN KUAN*

production of income.

70 *Supra*, notes 8 and 69.

71 *Supra,* note 8, at 991.

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