AQP *v* Comptroller of Income Tax
[2013] SGCA 3

Case Number : Civil Appeal No 139 of 2011

Decision Date : 16 January 2013

Tribunal/Court : Court of Appeal

Coram : Chao Hick Tin JA; Andrew Phang Boon Leong JA; V K Rajah JA

Counsel Name(s) : Nand Singh Gandhi and Li Weiming Mark (Allen & Gledhill LLP) for the appellant; David Chong SC, Lee Cheow Han (Attorney-General's Chambers), Liu Hern Kuan, Julia Mohamed and Joyce Chee (Inland Revenue Authority of Singapore) for the respondent.

Parties : AQP — Comptroller of Income Tax

Revenue Law – Income Taxation – Deduction

[LawNet Editorial Note: The decision from which this appeal arose is reported at [2012] 1 SLR 185.]

16 January 2013 Judgment reserved

Andrew Phang Boon Leong JA (delivering the judgment of the court):

Introduction

1 This is an appeal against the decision of a High Court judge ("the Judge"), holding that the loss suffered by the taxpayer ("the Appellant") due to misappropriation of its funds by its ex-Managing Director ("the Ex-MD") does not qualify as a deduction under s 14(1) of the Income Tax Act (Cap 134, 2008 Rev Ed) ("the Act") (see *AQP v Comptroller of Income Tax* [2012] 1 SLR 185 ("the Judgment")).

Facts

2 The Appellant is a company that was listed on the Stock Exchange of Singapore Dealing and Automated Quotation (SESDAQ) in 1995 and, subsequently, the Singapore Exchange Limited (SGX) Mainboard on 2 February 1998. [note: 1] The Ex-MD was the Managing Director of the Appellant from 20 October 1995 to 1 December 1999, when he was dismissed for misappropriating the Appellant's funds. [note: 2] In 2001, the Ex-MD was convicted of criminal breach of trust after the District Judge ("the DJ") found that he had, on various occasions between September 1997 and August 1998, falsely claimed to have paid money to the Appellant's suppliers and customers, either as deposits for goods or as loans, and then "reimbursed" himself from the Appellant's funds (see *Public Prosecutor v Kwek Chee Tong* [2001] SGDC 194 ("*PP v KCT*"). [note: 3]

3 As a result of these misappropriations, the Appellant lost $12,272,917 ("the Loss"). [note: 4] The Appellant made a provision for doubtful debts including the Loss in its statutory accounts for the year ended 31 December 1999 but did not claim a deduction for the Loss in its income tax return for the Year of Assessment 2000. [note: 5] Although the Appellant obtained judgment against the Ex-MD in 2003 for the money misappropriated, it could not recover anything and the Ex-MD was

subsequently declared a bankrupt. [note: 6]

4 On 15 December 2005, the Appellant applied to the Respondent for relief under s 93A of the Act ("s 93A") on the basis that it had made an "error or mistake" within the meaning of that section by not claiming a deduction for the Loss under s 14(1) of the Act in its income tax return for the Year of Assessment 2000. [note: 7] On 1 December 2008, the Respondent made a determination that no relief would be granted as no "error or mistake" had been made. [note: 8]

The decision of the Income Tax Board of Review

5 On the Appellant's appeal to the Income Tax Board of Review ("the Board"), the Board upheld the Respondent's determination (see *AQP v Comptroller of Income Tax* [2010] SGITBR 1 ("the Board's Decision")). The appeal was on premised two grounds. The first ground, which is relevant to the present appeal, was that the Loss arising from the Ex-MD's misappropriation occurred in the course of the Appellant's normal income-earning activities and therefore qualified for a deduction under s 14(1) of the Act. On the second ground that the Appellant's omission in claiming a deduction for the Loss was an "error or mistake" within the meaning of s 93A, the Board found that the omission was a decision made after due consideration that the Loss was not an allowable deduction under s 14 of the Act, and that *if the decision was a mistake* it was one of law falling within the purview of s 93A. However, this particular issue was rendered academic in view of the Board's decision on the first ground – to which we now turn. However, before proceeding to do so, we note that the Judge had also made some observations (albeit by way of *obiter dicta* as he had also, like the Board, found against the Appellant with regard to the first ground) in the Judgment (at [93]–[105]) with regard to the scope of s 93A. However, as the issue of the nature and scope of s 93A was not before this court, we do not propose to comment on the observations by either the Board or the Judge.

6 In considering the first ground of appeal, the Board referred to the English High Court decision of *Curtis (H M Inspector of Taxes) v J & G Oldfield, Limited* (1925) 9 TC 319 ("*Curtis*") as well as the subsequent Scottish decision of *The Roebank Printing Company, Limited v The Commissioners of Inland Revenue* (1928) SC 701, 13 TC 864 ("*Roebank*") and the English High Court decision of *Bamford (H M Inspector of Taxes) v A T A Advertising Ltd* (1972) 48 TC 359 ("*Bamford*"), where *Curtis* was considered. In brief, the facts of *Curtis* were that the Managing Director of the taxpayer company was, for many years, in sole control of the company's business, which was run very informally. Indeed, an investigation after his death revealed that there appeared to have been no auditors appointed and an almost entire absence of balance sheets for recent years. It also revealed that moneys had passed through the company's books which related to his private affairs (and *not* the company's business), amounting to some £14,000, which debt was due from his estate to the company. As this debt was valueless, it was written off as a bad debt. The General Commissioners allowed the company's claim to deduct this amount in computing its profits for assessment to income tax. On appeal, the High Court reversed the decision of the General Commissioners and held that the loss in question was not a trading loss and thus was not an admissible deduction for income tax purposes. The following passage from Rowlatt J's judgment (at 330-331) was cited by the Board (at [16] of the Board's Decision):

> When the Rule speaks of a bad debt it means a debt which is a debt that would have come into the balance sheet as a trading debt in the trade that is in question and that it is bad. It does not really mean any bad debt which, when it was a good debt, would not have come in to swell the profits. What the Commissioners have been misled by, in my judgment, quite clearly is this. They have allowed themselves to act under the impression that they were taxing the Company on what the Company in a loose way had made and secured. In point of law they were engaged in

assessing the profits of the Company's trade, not of the Company itself but of the Company's trade, and I have to consider whether there is the least ground for supposing that losses of these sums resulting in this bad debt were losses in the trade. I quite think ... that if you have a business (which for the purposes of to-day at any rate I will assume) in the course of which you have to employ subordinates, and owing to the negligence or the dishonesty of the subordinates some of the receipts of the business do not find their way into the till, or some of the bills are not collected at all, or something of that sort, that may be an expense connected with and arising out of the trade in the most complete sense of the word. But here that is not this case at all. This gentleman was the Managing Director of the Company, and he was in charge of the whole thing, and all we know is that in the books of the Company which do exist it is found that moneys went through the books into his pocket. I do not see that there is any evidence at all that there was a loss in the trade in that respect. It simply means that the assets of the Company, moneys which the Company had got and which had got home to the Company, got into the control of the Managing Director of the Company, and he took them out. It seems to me that what has happened is that he has made away with receipts of the Company *dehors* the trade altogether in virtue of his position as Managing Director in the office and being in a position to do exactly what he likes.

7 The Board observed (at [17] of the Board's Decision) that the Ex-MD was a substantial shareholder of the Appellant: both directly and through his family company ("D Pte Ltd"), his interest or deemed interest ranged between 12.8% and 14.9%. The Board proceeded to hold (*ibid*) that:

> As a substantial shareholder and Managing Director, and based on the evidence, the Ex-MD was in the language of Rowlatt J ... *"in a position to do exactly what he likes".* This was as found by the [DJ] in [*PP v KCT*]. At paragraph 284 of his Grounds of Decision, the [DJ] stated:
>
> > *"The accused was Managing Director of both [AQP] and [D Pte Ltd]. The evidence revealed that no one questioned his instructions. There was total trust reposed in the accused by virtue of his senior management position. In evidence he said that he need not have to tell anyone about, and (as a fact) he had complete control over, the usage of [AQP's] funds. He had access to millions of dollars as [AQP] was a public listed company ..."*
>
> [emphasis in original]

8 The Board concluded (at [21] of the Board's Decision) that in line with the principles stated in the case authorities, the Loss did not qualify for deduction under s 14(1) of the Act and the appeal was accordingly dismissed.

The decision of the Judge

9 On the Appellant's appeal to the High Court, the Judge upheld the Board's decision that the Loss did not qualify for a deduction under s 14(1) of the Act. According to the Judge, *Curtis* laid down the following test which determines the tax-deductibility of loss incurred by a company as a result of defalcation by its employee (see the Judgment at [54]):

> Having surveyed the various approaches in different Commonwealth jurisdictions, I have come to the view that the correct understanding of the *Curtis* test was applied by the Board. The correct understanding of the *Curtis* tes[t], in my view, is as follows: Did the defalcator possess an "overriding power or control" in the company (*ie*, in a position to do exactly what he likes) and was the defalcation committed in the exercise of such "power or control"? If so, the losses which result from such defalcations are not deductible for income tax purposes.

We will refer to this test as the "overriding power or control" test. The Judge held that the "overriding power or control" test should be adopted in Singapore because the Commonwealth cases are, on the whole, in greater support of this test (see the Judgment at [56]–[68]) and that this approach is legally sound and justifiable in policy (see the Judgment at [69]–[83]).

10 The Judge was of the view that the Board had correctly relied on the findings of fact of the DJ (at [7] above; see also the Judgment at [89]). Applying the "overriding power or control" test to the DJ's findings, the Judge held that the Ex-MD possessed an overriding power or control in the Appellant and that the defalcations were committed in the exercise of such power or control (see the Judgment at [88]–[92]). The appeal against the Board's decision was therefore dismissed.

Issue on appeal

11 The Appellant then appealed to this court. As the Appellant aptly put it, the sole issue in this appeal is whether the Judge had erred in holding that the Loss did not qualify for deduction under s 14(1) of the Act.

Our decision

Section 14(1) of the Act

12 Section 14(1) of the Act reads as follows:

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

The law in other jurisdictions

13 The relevant case law in a variety of jurisdictions was dealt with in perceptive detail by the Judge. We therefore do not propose to rehearse the analysis by the Judge and will deal with the relevant case law only to the extent that it is necessary for the decision of the present appeal.

14 Section 14(1) of the Act (reproduced above at [12]) is deceptively simple. More importantly, in so far as the present appeal is concerned, a plain reading of s 14(1) of the Act would – at least at first blush – suggest that the Loss (by its very nature) would not fall within its ambit and that this appeal must consequently fail. This is because defalcations by an employee would not usually be considered an "*outgoing*" or an "*expense*" which is "wholly and exclusively *incurred* ... in the production of income" within the meaning of s 14(1) of the Act [emphasis added]. However, this is not the approach adopted by the courts of the various jurisdictions considered both in the present appeal as well as in the proceedings below. Indeed, whilst it was common ground in the court below that South Africa was alone in adopting the strictest view inasmuch as defalcations by employees would not qualify in all circumstances for deduction under the corresponding South African legislation, this is *not*, in fact, the case – at least at the present time. The cases relied upon for this extremely strict proposition (also cited at [50]–[51] of the Judgment) were decided a long time ago (*viz*, *Lockie Bros Ltd v Commissioner for Inland Revenue* (1922) 32 SATC 150 ("*Lockie Bros*") and *Income Tax Case No. 298* (1934) 8 SATC 58). However, in the leading South African treatise on income tax law, it was observed as follows (see J A Arendse et al, *Silke: South African Income Tax 1999* (Butterworths,

Durban, 1998) at para 7.8.17):

> If the loss is due to defalcations by the managing director or owner of the business, it will not be allowed as a deduction ([*Lockie Bros*]).
>
> Losses suffered due to defalcations by subordinate employees will be allowed as a deduction since the risk of theft by such employees can be regarded as being inseparable from the carrying on of the business. These losses generally arise from a risk that is always present when subordinate employees are engaged in performing the duties entrusted to them.

15 Further, in another treatise, it was observed – in a similar vein – as follows (see R C Williams, *Income Tax in South Africa - Law and Practice* (Butterworths, Durban, 1996) at para 19):

> In *COT v Rendle*, the Appellate Division of the High Court of Rhodesia attempted to reconcile the conflicting decisions. The case concerned a firm of chartered accountants which, in the course of its business, received moneys on behalf of its clients. One of the clerks employed by the firm misappropriated certain of these moneys and also moneys belonging to the firm. The court held that the amount misappropriated from the amounts collected on behalf of the clients was deductible, but not the amount misappropriated from the firm's own funds. The court held that the deductibility of fortuitous expenditure of the kind in issue depends on whether the *chance* or *risk* of its being incurred is sufficiently closely connected with the business operations, and not on whether the actual expenditure itself (should it eventuate) is sufficiently closely connected with those business operations. The court held further that the broad general test to be applied in relation to the deductibility of fortuitous expenditure was that the taxpayer must show that the risk of the mishap which gave rise to the expenditure was inseparable from or a necessary incident of the carrying on of the particular business. The court explained the decision in *Lockie Bros* on the basis that the defalcations in that case were by a managing director and not a subordinate employee, and that the 'risk of theft by a managing director can hardly be regarded as inseparable from the carrying on of the business'.
>
> Applying these principles to the facts before it, the court held that the misappropriation of clients' funds by the firm's clerk was a reasonably incidental risk in relation to the taxpayer's business, but that in the absence of evidence as to the circumstances in which the misappropriation of the firm's own funds had occurred, the taxpayer had failed to discharge the onus of proving that the amount was deductible.
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> [emphasis in original; footnotes omitted]

16 The decision referred to by the learned author quoted in the preceding paragraph (*viz*, *Commissioner of Taxes v Rendle* (1965) (1) SA 59 (SRAD), 26 SATC 326) was a decision of the Appellate Division of the High Court of Southern Rhodesia. There have also been also other South African decisions in which losses which flowed from defalcations by relatively junior employees were allowed as deductions (see *eg*, *Income Tax Case No 1242* (1975) 37 SATC 306 and *Income Tax Case No 1383* (1978) 46 SATC 90).

17 Put simply, the legal position in South Africa in so far as the issue of deductions in the context of defalcations by employees is concerned appears – contrary to the views of both parties – to be consistent with that adopted in other jurisdictions. Indeed, counsel for the Respondent, Mr Liu Hern Kuan, conceded in the course of oral submissions before the court, that the (present) South African position was not that which was accepted by the parties before the Judge in the court below.

18 Turning to the specific arguments, counsel for the Appellant, Mr Nand Singh Gandhi ("Mr Singh"), argued, first, that *Curtis* did not stand for the proposition which was adopted by the Judge in the court below (*viz*, the "overriding power or control" test). At this juncture, we note that the Judge rejected the alternative test which was proffered by Mr Singh on behalf of his client (*viz*, the "in the course of normal income-earning activities" test), as follows (see the Judgment at [52] and [55]):

> [The Appellant argued that] [t]he Commonwealth cases support the [A]ppellant's understanding of the *Curtis* test ... - *ie*, *whether the misappropriation occurred in the course of the [A]ppellant's normal income-earning activities and not outside them*.
>
> ...
>
> I recognise that this test which I adopt is much narrower in allowing for the deductibility of defalcation losses as compared to the test submitted by the [A]ppellant. I find the [A]ppellant's understanding of the *Curtis* test undesirably wide and I do not think that it should be applied in Singapore.
>
> [emphasis added]

19 More importantly, Mr Singh submitted that *Curtis* actually supported the "in the course of normal income-earning activities" test instead. Indeed, he also argued that the legal position in Canada, Australia and New Zealand also embodied the test just mentioned. The difficulty with Mr Singh's argument in this particular regard, however, is the fact that the various decisions he cites in the context of Canada, Australia and New Zealand (in which deductions in respect of losses resulting from employee defalcations were allowed) all concerned employees who were *not* in a position of overriding power or control. Put simply, the same results (*viz*, the allowing of a deduction) could have been arrived at by applying the "overriding power or control" test adopted by the Judge. This may be briefly illustrated by highlighting the following points from the decisions which Mr Singh relied on. Before proceeding to consider, in the briefest of fashions, these decisions, it might be apposite to note that the "overriding power or control" test is, in fact, *consistent with* the "in the course of normal income-earning activities" test – a point to which we will return below (at [25]). Turning, then, to the decisions just mentioned:

(a) In the Supreme Court of New Zealand decision of *Commissioner of Taxes v Webber* [1956] NZLR 552, the defalcator was only a part-time book-keeper.

(b) In the Supreme Court of New Zealand decision of *W G Evans & Co Ltd v Commissioner of Inland Revenue* [1976] 1 NZLR 425, the court described the defalcator in the following manner (at 432):

> [The defalcator] was in nothing like the position of the managing director in *Curtis's* case who could exercise an overriding control to take the money independently of the company's normal operations. Although a director, [the defalcator] was nothing more than the company's accountant so far as these defalcations were concerned. The money came into his control during the normal revenue receiving operations of the company, and he was expected to handle these funds in accordance with the policy decisions of [the majority shareholder].

(c) In the Tax Court of Canada decision of *Cassidy's Limited (formerly Packer Floor Coverings Ltd) v The Minister of National Revenue* 89 DTC 686 ("*Cassidy*"), the court made the following

observations about the defalcator (at 693):

> [The defalcator] commenced defrauding [the company] ... when he was controller and before his appointment ... to vice-president and general manager of [the company]. When he began his theft of funds he did not have "complete discretion" over the operations of [the company] and was responsible to [the president of the company]. Even after his appointment as general manager he was obliged to report monthly to, and follow rules determined by, his superiors. [The company's] business was controlled by [the defalcator's] superiors. This is not a case like *Curtis* ... for example, where the person defrauding his employer was in sole control of the employer's business.

(d) In the Federal Court of Canada (Trial Division) decision of *Parkland Operations Limited v The Queen* 90 DTC 6676, the defalcators were two "new" shareholders of a company who made withdrawals from the company's operating line of credit despite the understanding of the shareholders that withdrawals required one signature from either of two "primary" shareholders and another signature from any of the four "new" shareholders. The court held (at 6680) that the defalcators "misappropriated the money while dealing with it in the course of the company's activities, and not by exercising some overriding control over the funds which existed outside of those activities".

(e) The High Court of Australia decision of *Charles Moore & Co (WA) Pty Ltd v Federal Commissioner of Taxation* (1956) 95 CLR 344 was not concerned with employee defalcations at all; it dealt, instead, with the deductibility of loss arising from a robbery.

20 However, what is of pivotal importance in so far as the resolution of the present appeal is concerned is *not* the mere ritualistic recitation of any given test as such but, rather, ascertaining which test is *undergirded (and hence justified) by logic, principle and commonsense*. We therefore turn, now, to consider both the "overriding power or control" test as well as the "in the course of normal income-earning activities" test to ascertain which test ought to be preferred in Singapore based on the criteria just mentioned.

Which test ought to apply in Singapore?

21 As already mentioned, Mr Singh argued strenuously that the "in the course of normal income-earning activities" test ought to apply. He argued – equally, if not more, strenuously – that the "overriding power or control" test ought not to apply. In so far as the latter argument was concerned, Mr Singh stated that the "overriding power or control" test would lead to great uncertainty in the law. With respect, Mr Singh was conflating the issue of uncertainty with the *application* of the law to the facts of the given case. Both are not coterminous with each other. More importantly, the latter is an inevitable fact (indeed, given) of legal life. This is particularly so in the context of income tax law. Indeed, the fact that it is impossible to designate a normative rule for each and every conceivable fact situation explains, in part at least, why s 14(1) of the Act itself was only framed in a very broad fashion. It is important to reiterate the fundamental point (or distinction) just made to the effect that the *very nature* of a rule (which is, *ex hypothesi*, *universal* and which, more importantly, must possess the *normative* force which *flows from* such universality) *distinguishes* it from the *factual* matrix *to which* it is *applied*. *Factual* matrices, which lie in the sphere of the *particular*, do not, on the other hand, possess any normative force as such but are also important inasmuch as they constitute the material *to which* the (*universal*) rules (for example, s 14 of the Act) are applied.

22 On the other hand, the "in the course of normal income-earning activities" test is, in our view, much broader than the "overriding power or control" test – a point noted by the Judge in the court

below (see the Judgment at [55]; also reproduced above at [18]). Indeed, if the former test were adopted (as argued for by Mr Singh), *any and every* defalcation by *any and every* employee would *almost always be a permissible deduction pursuant to s 14*. In our view, this is undesirable. Mr Singh, on the other hand, argued that such a consequence would not necessarily follow. He raised the example of an employee who takes money from the safe of his employer. In Mr Singh's view, such an employee would have committed an act which was *outside* the course of the employer's normal income-earning activities. Whilst attractive at first blush, we do not think that this particular example or illustration is helpful. Indeed, it leads to the very uncertainty which Mr Singh sought to attribute to the "overriding power or control" test. In particular, this would mean that there would be a *legal* distinction between the situation raised by Mr Singh and the situation concerning the very *same* employee who, instead of stealing the said money only after it was transferred to the employer's safe, opted to steal it whilst it was still in the till. With respect, we find such a distinction artificial in the extreme.

23 It is of the first importance to note that the reason why the courts generally (and across jurisdictions) allow deductions in so far as defalcations by employees who do not have overriding power or control in their respective organisations are concerned is the fact that such defalcations are an inevitable fact of commercial life in general and the conducting of the business concerned in particular. Put simply, the granting of such deductions is premised on *commercial reality*. As importantly, such a reality is – in turn – premised on the fact that it is *practically impossible to have the appropriate checks and balances which would prevent such defalcations from taking place.* This is particularly the case in so far as large organisations are concerned – hence, the quintessential illustration in many of the cases of the defalcation by the cashier of funds from his or her employer's till. For these reasons, it was observed by Brightman J in *Bamford* (at 368) that:

> [Counsel for the taxpayer] submitted that there is no logical distinction to be drawn between petty theft by a subordinate employee and massive defalcation by a director. In my view there is a distinction. I can quite see that the Commissioners might find as a fact that a £5 note taken from the till by a shop assistant is a loss to the trader which is connected with and arises out of the trade. *A large shop has to use tills and to employ assistants with access to those tills. It could not trade in any other way*. [emphasis added]

The following observations by Rich J in the High Court of Australia decision of *The Commissioner of Taxation (New South Wales) v Ash* (1938) 61 CLR 263 (at 277) may also be usefully noted (see also *per* Latham CJ, *ibid* at 273–274 and *per* Dixon J, *ibid* at 281 and 282):

> ... The *defalcations of a partner* appear to me to stand in a *different position* from *the petty larcenies of servants and the leakages through carelessness or dishonesty to which the revenues of most profit-earning organizations are exposed.* There is no difficulty in understanding the view that losses or outgoings incurred as *an expedient* aid to the more satisfactory working of an undertaking over a considerable interval of time should be allowed as deductions notwithstanding that no immediate, direct or tangible result can be reflected in revenue. This court has more than once acted upon such a view. There is *no difficulty in understanding* the view that ***involuntary*** *outgoings and* ***unforeseen or unavoidable*** *losses should be allowed as deductions when they represent that kind of casualty, mischance or misfortune which is* ***a natural or recognized incident*** *of a particular trade or business the profits of which are in question. These are* ***characteristic incidents*** *of the systematic exercise of a trade or the pursuit of a vocation.* [emphasis added in italics and bold italics]

24 However, and as alluded in the passages just quoted in the preceding paragraph, the situation is radically different where defalcations are effected by employees who have overriding power or

control in their respective organisations. Checks and balances can – and ought to be – in place to prevent such overriding power or control from being abused by the employee concerned, hence resulting in the defalcations perpetrated by that employee. More importantly, it is not impractical – unlike the "traditional" situation referred to in the preceding paragraph – to institute such checks and balances. However, it is equally important to emphasise that the law does *not* demand a *perfect* system of checks and balances for this would place an unfair – indeed, intolerable – burden upon the taxpayer. Hence, if a *sufficient* system of checks and balances has been put in place by the taxpayer and defalcations nevertheless occur as a result of an employee still managing to abuse his or her position of overriding power and control, the court would generally permit a deduction for such defalcations pursuant to s 14 of the Act. In this regard, what constitutes a sufficient system of checks and balances would naturally be fact-sensitive and would therefore vary from situation to situation, depending on the precise factual matrix and context concerned. It is important to reiterate a point already made above (at [21]) to the effect that such factual inquiries would not result in uncertainty in the law since the application of the relevant legal rule(s) and principle(s) to any given fact situation is an inevitable and given fact of legal life.

2 5 *If* the taxpayer concerned does *not* put in place a sufficient set of checks and balances with the result that overriding power or control is abused by the employee concerned, then it is logical, fair as well as commonsensical, in our view, for the Respondent to *refuse* the taxpayer concerned a deduction for such defalcations pursuant to s 14 of the Act. Indeed, if the taxpayer, who, *ex hypothesi*, could have prevented (or at least made a proper attempt to prevent) the defalcation concerned by putting a sufficient set of checks and balances in place but chose not to do so, that omission would, in our view, *break* the *nexus* to the production of income that is an inherent requirement in s 14 of the Act itself. This was also the view of Lord President Clyde in *Roebank* where he made the following observations on the facts of that case (at 875-876):

> If it were legitimate for us to make an inference of fact from the facts stated in the Case, I should be disposed to think that the managing director was using the Company as his banker. But it is, I think, enough to say that *the financial indulgence shewn to him by the Company went far beyond anything which could be justified by, or could be consistent with, any trading interest of the Company. If so, then the loss resulting from the granting of that indulgence cannot form a legitimate or proper deduction in the ascertainment of the Company's trading profits.* [emphasis added]

Looked at in this light, the "overriding power or control" test is not only desirable but is also logical, principled as well as consistent with commercial reality and practice. It is also important to reiterate that this particular test is, in fact, *wholly consistent with the general law* relating to deductions as embodied within s 14 of the Act itself – in particular, the requirement of a *nexus*.

26 We further note that the "overriding power or control test" is not so different from what a leading text regarded to be the prevailing practice before the Judge's decision in this case. In the *Singapore Master Tax Guide Manual* vol 1 (CCH Asia Pte Ltd, 2012), the learned authors observe as follows (at para 1066):

> Whereas a loss arising from the negligence or dishonesty of subordinate staff *prima facie* ranks for deduction against profits, the position is not the same where the negligence or dishonesty is committed by persons who are in managerial control of the business ([*Curtis*]; [*Bamford*]). A loss arising from the misappropriation of company funds by a manager is not deductible from income as it does not take place in the usual course of the company's business ...
>
> ***This principle was upheld in [the Judgment] ...***

[emphasis added in bold italics]

27 It should, however, be noted that another work seems to have adopted a somewhat more ambiguous approach, focusing (it appears) on the *mode* in which the defalcation has taken place (see *The Law and Practice of Singapore Income Tax* (LexisNexis, 2011) at para 4.166). As pointed out above (at [22]), however, this might not be the best approach. It would, in accordance with the approach adopted in this judgment, be preferable not to draw fine distinctions based on the mode in which the defalcation concerned has taken place but, rather, to permit deductions for losses from defalcations which have a sufficient nexus to the production of income in relation to the taxpayer's business (as contemplated by s 14 of the Act) – which nexus would, *ex hypothesi*, be *broken* if, for example (and as noted above), the taxpayer concerned does not put in place a sufficient set of checks and balances with the result that an employee with overriding power or control is enabled to (and in fact does) embezzle the taxpayer's funds. Where such a nexus is broken, then, of course, no deduction is permissible under s 14 of the Act.

28 However, and this may have been neglected previously, it is also important to adopt an approach towards the "overriding power or control" test which emphasises substance over form. To this end, we are of the view that the "overriding power or control" test must be viewed from *not only* legal *but also* factual points of view. For example, the *apparently* high office of an employee might *not necessarily* entail an overriding power or control over the organisation (and its activities) residing within that particular employee *in fact*. If so, then, consistently with the principles set out above, there is no need for the court to even inquire whether a sufficient system of checks and balances had been put in place by the taxpayer. It is, in the final analysis, of course a question of *fact* which the court has to decide upon. In this regard, we would, just as the court in *Cassidy* did, reject the proposition that "simply because a theft or defalcation was committed by a senior employee, the losses resulting from such a commission are not deductible by the employer in computing income for tax purposes" (see *Cassidy* at 691). To take a contrasting example, what if the employee does not hold a particularly high post within his or her organisation but nevertheless wields a tremendous amount of *de facto* authority as well as power within that organisation? We would think that if such *de facto* authority and power result in the employee concerned having – *ex hypothesi*, in point of fact – an overriding power or control over the organisation itself, then that would, in our view, suffice to result in the taxpayer concerned *not* being allowed a deduction (pursuant to s 14(1) of the Act) *if* that particular taxpayer had *not instituted sufficient checks and balances*. If, however, a sufficient set of checks and balances *had* been instituted, then we see no reason in principle why the taxpayer ought to be denied a deduction under s 14(1), notwithstanding that the employee concerned had otherwise wielded a tremendous amount of *de facto* authority and power within the organisation concerned. Similarly, whether there is a sufficient set of checks and balances should be an inquiry that focuses on substance rather than form. In a case where there exist checks and balances "on paper", for example in the company's constitutional documents, but these are not given effect to in practice, we would agree with the Judge's view (at [85]–[86] of the Judgment) that the "overriding power or control" test ought to be applied to the true arrangements in the company:

> 85 In my view, the appellant is mistaken in assuming that the *Curtis* test is merely a test of the legal arrangements within a firm ... A company could easily draw up legal provisions which purportedly govern what its directors can or cannot do, but be nonchalant in checking whether its directors abide by those provisions.
>
> 86 Therefore, the test of whether the defalcator was "in a position to do exactly what he likes" should be a test of the factual arrangements within the company. Thus, while it would be rare to find listed companies like the appellant legally giving its directors unbridled power, the *Curtis* test should be applied to pierce through such legal facades and penalise companies which factually did

give its directors unjustified overriding power or control...

29 Turning to a closely related (albeit intensely *practical*) point, we are of the view that the onus of demonstrating to the relevant tax authorities (here, the Respondent) that the employee concerned was not placed in a position of overriding power or control *or* that, if he or she had been so placed, that a sufficient system of checks and balances *had* indeed been instituted, *notwithstanding* the fact defalcations had *still* been effected by the employee concerned, lies on the taxpayer concerned – bearing in mind, of course, the respective parties' evidential burdens as well as the legal burden of proof, the latter of which lies throughout with the taxpayer (reference may be made in this regard to the decisions of this court in *Loo Chay Sit v Estate of Loo Chay Loo, deceased* [2010] 1 SLR 286 (at [14]) and *Zim Integrated Shipping Services Limited and others v Dafni Ignal and others* [2011] 1 SLR 862 (at [11]–[13])).

30 Although there are *also* at least some *elements* of *policy* which *may* be utilised in order to justify the "overriding power or control" test, we would agree with Mr Singh that references to "policy" (in particular, the purpose of *deterrence* in the context of the present proceedings) should be minimised, if not eradicated altogether. It may not be a satisfactory approach to have substantive recourse to what are, in the final analysis, policy factors that are more appropriately assessed by *Parliament* (as opposed to the courts). However, that having been said, in order to *avoid* a formalistic approach, it is imperative, in our view, *to bear the underlying likely policy considerations in mind*. The "overriding power or control" test (which we have endorsed above) ought to be justified, *in the main*, by *the ability of the taxpayer to establish sufficient checks and balances in the organisation and whether the failure to do so confers an overriding power or control to the employee who effected the defalcations concerned*. Whilst we do not disagree with the aim of *deterring* organisations from leaving the powers of their directors and shareholders unchecked (see generally the Judgment at [76]–[78]), this plays – at best – a *relatively minor* role in *justifying* the adoption of the "overriding power or control" test.

Application of the test in the present appeal

31 As noted above at [10], the Judge held that the Ex-MD was in fact in a position of overriding power and control and, hence, the deduction sought by the Appellant could not be allowed. In arriving at his conclusion, he relied upon the findings in the *criminal* proceedings against the Ex-MD in *PP v KCT*. Whilst these findings were relevant, they did not, in our view, furnish a full picture in relation to the proceedings in the present case. In particular, the Appellant itself was not, of course, a party to the criminal proceedings and therefore did not have the opportunity, *inter alia*, to proffer evidence as to whether or not it had, in fact, instituted a proper system of checks and balances. In any event, such evidence would not have been as significant in so far as the *criminal* proceedings against the Ex-MD were concerned. However, the Appellant ought to have been given the opportunity in *these* proceedings to proffer the evidence just mentioned. Indeed, it ought, in our view, *also* have been given the opportunity or choice to challenge (at a *prior or threshold* stage) the findings of the court in the criminal proceedings to the effect that the Ex-MD did in fact possess overriding power or control in the organisation in the first place.

Conclusion

32 In the circumstances, and absent any settlement between the parties themselves, we are of the view it would be just and fair if these proceedings are remitted to the Board in order for the necessary evidence to be adduced with regard to (a) whether the Ex-MD was in a position of overriding power or control for the purposes of the present (civil) proceedings and, if so, (b) whether a sufficient system of checks and balances had been put in place by the Appellant on the facts of

this particular case. The Board should also then proceed to render a decision thereon in accordance with the test set out in this judgment, and we so order. The test just referred to is the "overriding power or control" test, the application of which (when applied in the context of the facts of *the present case*) entails an inquiry as to whether or not the taxpayer's employee had an overriding power or control in the organisation *and, if so, whether* the taxpayer had instituted a sufficient set of checks and balances intended to prevent defalcations of its funds by such employees. In all other situations, however (*viz*, where it is clear that the employee committing the defalcation of the taxpayer's funds had *no* overriding power or control and where it would therefore be impractical to institute a sufficient set of checks and balances to prevent defalcations by such employees), deductions for defalcations would (consistently with what we understand to be the existing legal rules and principles both in Singapore as well as in other common law jurisdictions) continue to be allowed pursuant to s 14(1) of the Act.

33 In the circumstances, we are of the view that the costs of this set of proceedings should be the Respondent's costs in the cause. The usual consequential orders will apply.

[note: 1] Appellant's Core Bundle vol 2, p 9 at para 2.

[note: 2] *Ibid*, p 10 at paras 4-5.

[note: 3] *Ibid*, paras 5-6.

[note: 4] *Ibid*, p 11 at para 8.

[note: 5] *Ibid*, para 8.

[note: 6] *Ibid*, para 7.

[note: 7] *Ibid*, para 8; Record of Appeal ("RA"), vol V (pt 1) at p 36.

[note: 8] *Ibid*, para 9; RA, vol V (pt 1) at p 77.