IA v Comptroller of Income Tax
[2005] SGHC 229

Case Number : DA 30/2004

Decision Date : 22 December 2005

Tribunal/Court : High Court

Coram : Woo Bih Li J

Counsel Name(s) : Teoh Lian Ee and Stacy Choong (Drew and Napier LLC) for the appellant; Liu Hern Kuan and David Lim (Inland Revenue Authority of Singapore) for the respondent

Parties : IA — Comptroller of Income Tax

Revenue Law – Income taxation – Deduction – Taxpayer incurring borrowing expenses, prepayment penalty and guarantee expenses relating to financing loan – Taxpayer seeking to deduct expenses against taxable income for years of assessment – Whether expenses capital in nature – Whether expenses deductible against taxpayer's taxable income for years of assessment – Sections 10(1)(a), 14(1), 14(1)(a), 15(1)(c) Income Tax Act (Cap 134, 2004 Rev Ed)

22 December 2005 *Judgment reserved.*

Woo Bih Li J:

Background

1 This is an appeal by a taxpayer company ("IA") against the decision of the Income Tax Board of Review ("the Board") dated 14 October 2004 in Income Tax Board of Review Appeal Nos 6 and 7 of 2002.

2 IA was incorporated as a property development company with a paid-up capital of $77,111,750. It purchased a parcel of land in the east of Singapore ("the Land") for development into a condominium project ("the Condo Project") for sale. The total purchase and development costs of the Land and the Condo Project amounted to approximately $403m.

3 IA had obtained a loan of $113m from a syndicate of banks ("the Syndicated Loan") to finance the purchase price of the Land and the development costs of the Condo Project. The interest rates payable on the Syndicated Loan ranged from between 4.3834% to 6.25% for the relevant years. The agreement for the Syndicated Loan expressly provided (at cl 1.08 and Sched 8 of the agreement) that the loan proceeds could only be used to finance the purchase of the Land and pay for certain development costs in connection with the Condo Project. It was undisputed that the Syndicated Loan was in fact used to finance the purchase of the Land and certain development costs. The Syndicated Loan was to be repaid 48 months from the date of first drawdown of the land loan component or 30 June 1997, whichever was earlier, but there was provision to allow early repayment.

4 The total amount of interest payable under the Syndicated Loan for IA's financial year 1994 alone was approximately $4.9m. The Comptroller of Income Tax ("CIT") does not dispute that interest is deductible against IA's taxable income under s 14(1)(*a*) of the Income Tax Act (Cap 134, 1994 Rev Ed) ("ITA").

5 IA also incurred the following borrowing expenses in connection with the Syndicated Loan (the "Borrowing Expenses"):

(a)	Underwriting fee (based on 0.875% of $113m) payable to Citicorp Investment Bank (Singapore) Limited ("Citicorp") which acted as the arranger of the Syndicated Loan	$ 988,750
(b)	Agency fee payable to Citicorp as the agent for the syndicate of lenders	$ 10,000
(c)	Facility fee (based on 0.125% of $113m) payable to Citicorp upon signing of the Syndicated Loan	$ 141,250
(d)	Solicitor's fees and disbursements in connection with the Syndicated Loan	$ 98,946
(e)	Property Valuer's fees for valuation of the Land and the Condo Project as required under the Syndicated Loan	$ 23,914
		$1,262,860

6 As at 30 September 1994, IA had revenue receipts amounting to approximately $170m from progress payments made by purchasers of the apartments in the Condo Project. This sum, which was more than sufficient to repay the entire outstanding amount under the Syndicated Loan, was quarantined in the Project Account for the Condo Project (the "Project Account") as required under the Housing Developers (Project Account) Rules (Cap 130, R 2, 1997 Rev Ed). At that time, it could only be withdrawn if IA furnished a bank guarantee to the Urban Redevelopment Authority ("URA") for an amount equivalent to the amount to be withdrawn.

7 On 13 October 1994, IA obtained two bank guarantees for an aggregate sum of $100m to secure the release of $100m from the Project Account which was used to pay the Syndicated Loan earlier than the due date for payment. This released IA from its obligation to pay substantial interest under the loan. IA said it achieved interest savings of approximately $8m from this exercise.

8 As the Syndicated Loan was repaid on a date earlier than the next interest payment date, IA incurred a prepayment penalty amounting to $15,570 (the "Prepayment Penalty").

9 In order to obtain the bank guarantees, IA incurred the following expenses (the "Guarantee Expenses"):

(a)	Aggregate bank commission for three years (based on the interest rate of 0.875%)	$2,605,750.00

(b)	Aggregate agency fees for three years (based on the interest rate of 0.125%)	$ 383,100.00
(c)	Solicitors' fees and disbursements	$ 9,933.15
		$2,998,783.15

10 IA claimed deductions under s 14(1) of ITA for (a) the Borrowing Expenses, (b) the Prepayment Penalty and (c) the Guarantee Expenses (collectively, the "Relevant Expenses") against its taxable income for certain years of assessment, *ie*, 1998 and 1999. The claims were disallowed by CIT who took the view that the Relevant Expenses were capital in nature and therefore were not deductible. IA then appealed to the Board which dismissed IA's appeals. IA then appealed to the High Court.

Relevant provisions in the ITA

11 The provisions in the ITA which are relevant in the present case are ss 10(1)(*a*), 14(1), 14(1)(*a*) and 15(1)(*c*).

12 Section 10(1)(*a*) of the ITA provides that:

> 10—(1) Income tax shall, subject to the provisions of this Act, be payable at the rate or rates specified hereinafter for each year of assessment upon the income of any person accruing in or derived from Singapore or received in Singapore from outside Singapore in respect of—
>
> > (*a*) gains or profits from any trade, business, profession or vocation, for whatever period of time such trade, business, profession or vocation may have been carried on or exercised.

13 Sections 14(1) and 14(1)(*a*) of the ITA provide that:

> 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, *including* —
>
> > (*a*) except as provided in this section, any sum payable by way of interest upon any money borrowed by that person where the Comptroller is satisfied that the interest was payable on capital employed in acquiring the income. [emphasis added]

14 Section 15(1)(*c*) of the ITA provides that:

> 15—(1) Notwithstanding the provisions of this Act, for the purpose of ascertaining the income of any person, no deduction shall be allowed in respect of –
>
> > …

(*c*) any capital withdrawn or any sum employed or intended to be employed as capital except as provided in section 14(1)(*h*).

The Borrowing Expenses

15 It was not disputed by CIT that the Land and the apartments of the Condo Project formed part of IA's trading stock. This was part of the agreed facts before the Board. Before me, CIT initially also agreed that the Syndicated Loan was to acquire trading stock. However, subsequently, while Mr Liu Hern Kuan, counsel for CIT, was taking the position that the Syndicated Loan added to the capital of IA, Mr Liu sought to retreat from the position that the loan was to acquire trading stock. Bearing in mind the agreed facts before the Board, I am of the view that it is not open to CIT to suggest that the Syndicated Loan was not to acquire trading stock. Whether the Borrowing Expenses are in the circumstances of the case capital or revenue is another matter.

16 The Board said that it was not in dispute that the Syndicated Loan was incurred in the production of income and that, therefore, the Borrowing Expenses were "wholly and exclusively incurred" in acquiring the income under s 14(1) of the ITA. The issue was whether the Borrowing Expenses were prohibited from deduction under s 15(1)(*c*) of the ITA. I add that the Board treated the Prepayment Penalty as being of the same nature as the Borrowing Expenses (see [51] of the Board's Grounds of Decision). In reaching its conclusion, the Board placed much reliance on English cases on the rationale that s 15(1)(*c*) of the ITA is based on the English Rule 3(f) applicable to Cases I and II of Schedule D of the Income Tax Act, 1918, ("Rule 3(f)"). Rule 3(f) states:

> In computing the amount of the profits or gains to be charged, no sum shall be deducted in respect of … any sum employed or intended to be employed as capital …

17 In *EJ Bridgwater and WH Bridgwater v King (HM Inspector of Taxes* (1943) 25 TC 385 ("*Bridgewater*"), the appellants carried on business as public works contractors and land and estate developers. As developers, the appellants purchased lands which they developed by constructing roads and sewers and selling plots as building sites. For the purpose of purchasing and developing an estate, the appellants borrowed ₤15,000 with interest at 5% per annum and ₤6,500 payable by way of premium or bonus. Subsequently, as the lender was anxious to obtain repayment, it agreed to accept repayment with a reduced premium of ₤4,000 instead of the ₤6,500. The Special Commissioners decided that the ₤4,000 was not a proper deduction under Rule 3(f). Macnaghten J decided that there was ample evidence to support the decision of the Special Commissioners as the loan was not of a temporary character.

18 The emphasis on the distinction between a fluctuating temporary loan and a loan on a permanent footing appears to have stemmed from *Farmer (Surveyor of Taxes) v Scottish North American Trust, Limited* [1912] AC 118, 5 TC 693. There, Lord Johnston said in the Court of Session at 5 TC 693 at 698:

> It may be well said that if money is borrowed on a permanent footing, as from year to year, the capital of the concern is in a commercial sense enlarged thereby, and the business extended, whereas no commercial man would consider that his banking facilities were part of his capital, or the consideration he paid for them anything but an expense of his business.

19 In the House of Lords, Lord Atkinson said ([1912] AC 118 at 127, 5 TC 693 at 707):

> These authorities show that money borrowed by such a Company as the Appellant Company in this case in the fluctuating temporary manner in which it has been borrowed by them – the daily

borrowing and lending of money being part of their trade and business – is not to be treated under the Joint Stock Companies Act as "capital". There is nothing to show that the word should bear a different meaning in the Income Tax Acts when applied to the proceedings of Joint Stock Companies.

20 In *The European Investment Trust Company, Limited v Jackson (HM Inspector of Taxes)* (1932) 18 TC 1 ("*European Investment Trust*"), a question arose as to whether interest on loans was deductible. The General Commissioners refused the deduction. On appeal, Finlay J upheld this decision. At 18 TC 1 at 9 he said that it was "thoroughly well established by a long line of cases that [interest] is not deductible if it is in truth the interest on capital". At 18 TC 1 at 11 to 12, he said:

> Now, here it seems to me that the principle may be stated in this way: if you get a company dealing with money, buying or selling stocks or shares, Treasury bills, bonds, all sorts of things, and if you get that company getting, as such companies constantly do get, temporary loans from their bank – accommodation, I suppose, for sometimes twenty-four hours, or even less, sometimes for a good deal longer – if you get that sort of thing, then the interest on that money, the hire, so to speak, paid for that money, may properly be regarded as an expenditure of the business, an outgoing to earn the profits. On the other hand, if the truth of the thing is that by the payment of the interest the company does not obtain mere temporary accommodation, day to day accommodation of that sort, but does, in truth, add to its capital and get sums which are used as capital and nothing else, then I think that in that case all the authorities show that the deduction cannot properly be made.

The Court of Appeal dismissed the appeal of the taxpayer.

21 The decision in *European Investment Trust* in respect of interest on a loan was abrogated by legislation. In England, s 130 (f) of the Income and Corporation Taxes Act 1970 ("ICTA") states:

> 130. Subject to the provisions of the Tax Acts, in computing the amount of the profits or gains to be charged under Case I or Case II of Schedule D, no sum shall be deducted in respect of –
>
> > (f) any capital withdrawn from, or any sum employed or intended to be employed as capital in, the trade, profession or vocation, but so that this paragraph shall not be treated as disallowing the deduction of any interest.

22 In Singapore, s 14(1)(*a*) of the ITA specifically provides that interest upon any money borrowed by the taxpayer is deductible where CIT is satisfied that the interest is payable on capital employed in acquiring the income. In *T Ltd v Comptroller of Income Tax* [2005] 4 SLR 285 ("*T Ltd*"), Andrew Ang JC (as he then was) decided that s 15(1)(*c*) was never intended to apply to interest (see [69] of his judgment). He observed that the Singapore provision is worded differently from the English provision and said at [55] to [57]:

> 55 So much then as to how the UK provision was construed in the *European Investment Trust* case. Should the Singapore provision be interpreted likewise? Although counsel for the appellant argued cogently why it ought not [to] be likewise construed, he may have been a little generous in conceding that the language of the Singapore provision is close to its UK counterpart. As noted, the UK provision prescribes that:
>
> > [N]o sum shall be deducted in respect of … any sum employed or intended to be employed as capital …

In other words, "no sum … in respect of any sum employed as capital …" is to be deducted.

56 As framed, it is possible to construe the "sum" first referred to as separate and distinct from the second. On this basis, it did no violence to the language of the UK provision for the *European Investment Trust* case ([54] *supra*) to construe the first sum as being referable to interest while the second referred to the principal amount on which the interest accrued.

57 The Singapore provision is differently worded. It states:

> [N]o deduction shall be allowed in respect of … any sum employed or intended to be employed as capital.

The provision makes no mention of any sum other than the sum employed or intended to be employed as capital. Whereas the words "in respect of" in the UK provision could be read to mean "in connection with" without doing violence to the statutory provision, the same words "in connection with" could not, in my view, comfortably substitute for "in respect of" in the Singapore provision. It would immediately invite the question "Deduction of what?" To my mind, the words "in respect of" in the Singapore provision is the equivalent of "for" or "on account of". Thus, what is prohibited is the deduction of the sum employed or intended to be employed as capital.

23 I would add that under the ITA, interest is not treated as an exception to s 15(1)(*c*). Instead, it is treated as a specific illustration of outgoings and expenses mentioned in s 14(1). Indeed, under s 14(1)(*a*), interest is referred to as interest "payable on capital employed in acquiring the income". So, interest payable on such capital cannot be the capital employed which is referred to in s 15(1)(*c*). Accordingly, I agree with Ang JC's view that s 15(1)(*c*) applies only to the principal loan itself. This means that none of the Relevant Expenses is caught under s 15(1)(*c*). In my view, the Board was wrong in concluding that the Borrowing Expenses, as well as the Prepayment Penalty, were caught under s 15(1)(*c*).

24 As the Board said that it was not in dispute that the Borrowing Expenses were wholly and exclusively incurred in acquiring the income, then that should be the end of the matter for the Borrowing Expenses, as well as the Prepayment Penalty. However, in view of the substantive submissions made and the importance of the issue, I will go on to deal with the point as to whether the Borrowing Expenses, as well as the Prepayment Penalty, were revenue in nature or not. I will focus first on the Borrowing Expenses.

25 Coming back to English cases, in *Beauchamp (Inspector of Taxes) v FW Woolworth plc* [1987] STC 279, the taxpayer ran a chain of retail shops in the United Kingdom. In 1971, it borrowed 50m Swiss francs repayable after five years or earlier at the taxpayer's option. In 1972, it borrowed the same sum in Swiss francs also for a period of five years. The exchange control rules then in force provided that consent to such borrowing would be granted only if the loan were outstanding for a minimum period of five years. The taxpayer repaid the first loan six months early. The second loan was repaid on its due date. In both cases, the taxpayer incurred losses due to the depreciation of the sterling.

26 The Special Commissioners found the loans to have been loans arranged to tide the taxpayer over a short-term problem, namely, the failure of the taxpayer's trading activities to generate a sufficient cash flow to cover its commitments and day-to-day needs. On that basis, they found that the loans represented temporary facilities rather than permanent capital and that the loans were allowable deductions in computing profits of the taxpayer under s 130(f) of the Income and

Corporation Taxes Act 1970.

27 Hoffmann J allowed the Crown's appeal. He said at 293:

> The exchange losses are allowable as deductions only if the borrowings were themselves part of the taxpayer company's revenue transactions rather than accretions to the capital which it employed. An accretion to the taxpayer company's capital connotes some degree of permanence. Thus in *Farmer (Surveyor of Taxes) v Scottish North American Trust Ltd* [1912] AC 118, 5 TC 693, the Court of Session and the House of Lords held that short-term banking facilities, described by Lord Johnston as 'short in the sense that they were for short and indefinite periods, borrowed as occasion required, and repaid as opportunity permitted', were not additions to the company's capital. Lord Johnston contrasted such borrowings with a case in which 'money is borrowed on a permanent footing, as from year to year, the capital of the concern is in a commercial sense enlarged thereby, and the business extended'. A similar distinction between 'mere temporary accommodation' and sums which the company may be said to 'add to its capital' is made by Finlay J in *European Investment Trust Co Ltd v Jackson* (1932) 18 TC 1 at 12.
>
> Now if one applies this distinction I think that these loans cannot reasonably be regarded as anything other than accretions to the taxpayer company's capital. No one can describe a loan for a fixed term of five years as a mere temporary accommodation. The amount and the term were fixed, and the loan was for a substantial period. …
>
> The money was raised because the taxpayer company needed additional cash for its business. The purposes for which cash was required included both revenue items, like financing stock, and capital items, like enlarging shops.

At 295, he said:

> It seems to me that in attaching importance to what the taxpayer company was seeking to do, rather than to what it actually did, the commissioners misdirected themselves. The fact that the object of the borrowings was to deal with a temporary shortage of cash is irrelevant if the solution actually adopted was to make an addition to the taxpayer company's liquid resources sufficiently permanent to be regarded as an accretion to its capital. The rights issue contemplated as one solution would undoubtedly have fallen within this category and I think a five-year loan would do so also. The commissioners seem to have discounted the effect of the five-year term on the ground that the Bank of England insisted on this period. Again, it seems to me irrelevant that the taxpayer company borrowed for five years because for one reason or another it was not possible or convenient to obtain accommodation for a shorter period: what matters is what the taxpayer company actually did.
>
> In cases where there is no fixed term for repayment, or where the term is of a borderline nature, the use to which the money was put may throw some light on whether or not it was an accretion to capital. The terms of the borrowing must be examined in their factual context. …
>
> But this is not a doubtful case. The terms of the loans are in my judgment sufficient to make it clear that they constitute additions to the capital employed by the taxpayer company, and it does not matter whether they were intended to be employed in the making of payments of a revenue or of a capital nature. In this case evidence on that question would be of little help because it is clear from the evidence before the commissioners and the documents to which I have referred that the money was not intended to be used, and nor was it actually used, specifically for purposes of one character or the other. It was simply an addition to the taxpayer

company's general funds. It follows that there are in my judgment no relevant factors pointing to the borrowing being a revenue receipt which can displace the inference to be drawn from the terms upon which the money was actually borrowed.

At 296, he said:

> In deciding whether a loan is on revenue or capital account there can be no question of examining the nature of the asset or advantage gained by the company: it is always the same, namely, money. The only question is whether the terms of repayment or the circumstances in which it is likely to be repaid (or the use to which it is put may throw some light) make it appropriate to treat the money as a sufficiently permanent addition to the company's funds to be regarded as capital, and both the authorities and the practice of the accountants seem to me to show that the loans in this case unquestionably came within that description.

28 On appeal to the Court of Appeal, the taxpayer was successful, but on appeal to the House of Lords, the Crown was successful.

29 In *Beauchamp (Inspector of Taxes) v FW Woolworth plc* [1989] STC 510, ("*Beauchamp*") which was the House of Lords' decision, Lord Templeman said at 514:

> My Lords, in the course of business a trading company of the type exemplified by the taxpayer company can only earn profits if it provides for the payment of trading expenses and for the receipt of trading revenue. The most common form of provision is by means of a current account which may be in credit when earnings are received and in debit when expenses are paid out. The bank charges for providing the facilities afforded by the current account and for the sums involved in accepting cheques drawn on the account when it is overdrawn. The temporary and fluctuating borrowings incurred in transacting business are revenue transactions. On the other hand, a trading company which borrows unconditionally a fixed amount for a definite period may use the money generally for the purposes of its business or for any other purpose authorised by its constitution, and even when the money is employed in the business, the money may be laid out on income expenditure or capital expenditure. The taxpayer company could do as it pleased with 100m borrowed Swiss francs, provided that the application of the money was *intra vires* the objects of the taxpayer company.

He said at 516:

> Similarly, in a rough way, it is not a bad criterion of what is a capital borrowing as against what is an income borrowing to say that capital borrowing is a thing that is going to be borrowed once and for all, and income borrowing is a thing that is going to recur every year.

He said at 518:

> A loan is not an 'ordinary incident of marketing' unless, as the authorities show, the loan is temporary and fluctuating and is incurred in meeting the ordinary running expenses of the business.

He then cited the judgment of Hoffman J with approval.

30 I now come to the Hong Kong case of *Wharf Properties Ltd v Commissioner of Inland Revenue* [1997] AC 505 ("*Wharf*"). In *Wharf*, the taxpayer was a property development company which had acquired an old tramway depot for redevelopment of a commercial complex known as Times

Square. The taxpayer had borrowed money to fund the purchase. The loans were for short periods from a week to a month but were always renewed. During the two years in question, *ie* 1988 and 1989, Wharf Properties Ltd received licence fees from the tramway company. The question which arose was whether Wharf Properties Ltd was entitled to deduct the interest payments in calculating its taxable profits. The Privy Council decided that while the interest was *prima facie* deductible under s 16(1)(a) of the Inland Revenue Ordinance ("IRO"), it was caught by s 17(1)(c) of the IRO and hence not deductible.

31 Section 16(1) of the IRO states:

> … there shall be deducted all outgoings and expenses to the extent to which they are incurred during the basis period for that year of assessment by such person in the production of profits in respect of which he is chargeable to tax under this Part for any period, including –
>
> > (a) where the conditions set out in subsection (2) are satisfied, sums payable by such person by way of interest upon any money borrowed by him for the purpose of producing such profits …

Section 17(1)(c) of the IRO states that there shall be no deduction of "any expenditure of a capital nature".

32 Lord Hoffmann said at 511:

> From the point of view of the payer, however, a payment of interest may be a capital or revenue expense, depending upon the purpose for which it was paid. The fact that it is income in the hands of the recipient and a recurring and periodic payment does not necessarily mean that it must be a revenue expense. Wages and rent are income in the hands of their recipients; periodic payments, in return for services or the use of land or chattels respectively. But whether such payments are of a capital or revenue nature depends on their purpose. The wages of an electrician employed in the construction of a building by an owner who intends to retain the building as a capital investment are part of its capital cost. The wages of the same electrician employed by a construction company, or by the building owner in maintaining the building when it is completed and let, are a revenue expense.
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> For this purpose, their Lordships consider that there is no material distinction between interest and other periodic payments.

33 After referring to *Beauchamp*, he said at 512 and 513:

> Ordinarily, however, a loan to a trading company, whatever the purpose for which it is intended to be used, will be an addition to that company's capital. Mr Gardiner did submit that the shortness of the successive terms of the loans in this case was enough to make them revenue receipts, but their Lordships do not agree. The borrowing did not form part of the company's trading activities. …
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> Thus, while the question of whether money is intended to be used for a capital or revenue purpose is inconclusive as to whether its receipt is a revenue receipt or an addition to the company's capital, the purpose of the loan during the period for which the interest payment was made is critical to whether it counts as a capital or revenue expense. In the present case, during the whole of the two years in question, the loan was clearly being applied for the purpose of acquiring and creating a capital asset rather than holding it as an income-producing investment.

> It follows that the interest was being expended for a capital purpose.
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> …
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> It may be that the present case is unusual in the precision with which the purpose of the loan can be identified. In cases like [*Beauchamp*], where the borrowings are for the general purposes of the company and are spent on both capital and revenue account, it will be much more difficult to say whether a given interest payment is an expenditure of a capital or revenue nature. But this question did not arise in the *Beauchamp* case and there is no such difficulty in this one. Their Lordships think that in the present case a true and fair view of the taxpayer's transactions required the interest to be treated as an expense of the development.

34 As can be seen, the focus in *Wharf* was not so much on the temporariness of the loans but the purpose of the loans. Also, Ang JC pointed out in *T Ltd* that s 17(1)(c) of the IRO was wider than s 15(1)(*c*) of the ITA as was the English provision. Hence, as I have mentioned, Ang JC decided that interest was not caught by s 15(1)(*c*) of the ITA.

35 In the Canadian case of *Bennett & White Construction Co Limited v Minister of National Revenue* (1949) 49 DTC 514 ("*Bennett*"), the taxpayer borrowed money to carry on its contracting and construction business. The loans were secured by a guarantee which was given by individuals over various periods of time. The taxpayer made payments to these individuals as consideration for their guarantees. The question arose as to whether the money paid to the guarantors was a deductible expense or a payment "on account of capital" within s 6(b) of the Income War Tax Act, RSC 1927, c 97 (Can). The Supreme Court of Canada decided it was not deductible, relying on the Privy Council's decision in *Montreal Coke and Manufacturing Co v Minister of National Revenue* [1944] AC 126 ("*Montreal Coke*"). As CIT and the Board placed much reliance on *Bennett*, I will quote quite extensively from the judgments there. Locke J said at 516:

> I think the character of the payments in the present case does not differ in essence from those which were disallowed in the *Montreal Coke* case. They were, in my opinion, simply expenditures incurred in obtaining the capital to make the large deposits required, to purchase equipment and generally to finance the operations.

36 Estey J said at 517:

> This was not a borrowing of money on a temporary or short-term basis such as is necessary and incidental to the ordinary and usual transactions in the course of the appellant's business. In effect this line of credit made available to the appellant for an indefinite period the ability to borrow funds for the purpose of accepting contracts beyond the volume its paid-up capital and surplus would permit. The provision for the cancellation of the guarantee, having regard to the relation of the guarantors to the company, and the practice since 1934, does not detract from the conclusion that this line of credit provided a long-term basis upon which the company might obtain the funds it required.

37 He said at 519:

> The funds borrowed were therefore capital and the payments made to the guarantors constituted a part of the "financial arrangements" of the appellant. They are in principle identical with those dealt with by the Privy Council in [*Montreal Coke*], where the expenses of refinancing a bond issue in order to effect a low rate of interest and other savings were disallowed under sec.6(1)(a).

…

> The disbursements of the guarantors here in question were made not as interest on the money borrowed but as the purchase price for the guarantee that made borrowing under the line of credit possible. The appellant upon obtaining this line of credit was enabled to complete its financial arrangements at the bank, which enabled it to undertake the larger volume of business. Sums borrowed under such circumstances are capital and the sums paid are not deductible under the provisions of 6(1)(a).

38 Rand J said at 519:

> The conception of the statute however is an earning of income through the use of capital funds which in one form or another constitute the means and instruments by which the business is prosecuted; but that providing or organizing them must be clearly differentiated from the activities of the business itself has been lately reaffirmed by the Judicial Committee in [*Montreal Coke*].

39 He said at 520:

> Now the Crown has allowed the deduction of interest paid to the bank, and it must have been either on the footing that the day-to-day use of the funds was embraced within the business that produced the profit, or that the interest was within section 5, paragraph (b). But setting up that credit right or providing the banking facilities is quite another thing from paying interest; it is preparatory to earning the income and is no more part of the business carried on than would be the work involved in a bond issue. The lender might insist on being furnished with premises near the scene of the works; it might exact any other accommodation as the price of its willingness to provide funds; but all that would be outside the circumference of the transactions from which the income arises. Within the meaning of the Act, the premiums create part of the capital structure and are a capital payment: *Watney v. Musgrave*, (1880) 5 Ex. D. 241. They furnish a credit apparatus to enable the business to be carried on, and although they affect the distributable earnings of the company, they do not affect the net return from the business.

40 The case of *Montreal Coke* involved expenses incurred in a refinancing exercise. *Montreal Coke* is therefore relevant in respect of the Guarantee Expenses and not so much in respect of the Borrowing Expenses. I will come back to that case later.

41 In *Harry Silverman v Minister of National Revenue* [1960] CTC 262, a partnership was formed in November 1954. It engaged in the business of buying and selling real estate in Toronto until 31 March 1955 when it was dissolved. In that period, three properties were bought and sold. The transactions pertaining to two of the properties were in issue, *ie* 23 Cowan Avenue and 61 Beatrice Street ("the Cowan property" and "the Beatrice property" respectively).

42 The Cowan property was purchased on 20 December 1954. It was then mortgaged to secure repayment in five years of $4,200 and interest. The partnership received only $4,000 as the remaining $200 was a bonus exacted by the mortgagee. The Cowan property was sold on or about 21 February 1955 with the purchaser assuming the mortgage.

43 The Beatrice property was purchased on 22 November 1954. It was then mortgaged to secure repayment in five years of $6,500 and interest. The partnership received only $6,000 as the remaining $500 was a bonus exacted by the mortgagee. The Beatrice property was sold on 26 February 1955 with the purchaser assuming the mortgage.

44 Sections 12(1)(a) and (b) of the Income Tax Act, RSC 1952, c 148 (Can) state:

> 12.(1) In computing income, no deduction shall be made in respect of
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> (a) an outlay or expense except to the extent that it was made or incurred by the taxpayer for the purpose of gaining or producing income from property or a business of the taxpayer,
>
> (b) an outlay, loss or replacement of capital, a payment on account of capital or an allowance in respect of depreciation, obsolescence or depletion except as expressly permitted by this Part.

45 After referring to English authorities and to *Bennett*, Thurlow J of the Exchequer Court of Canada said at [18]:

> In the present case, while the loan secured by the partners by mortgaging 61 Beatrice Street was on its face not of a temporary nature I think it may in the circumstances be inferred that the partners expected to dispose quickly of the property in just such a transaction as subsequently occurred. From their point of view the borrowing can, I think, accordingly be regarded as temporary since they did not expect to have the property for long and the assumption and retirement of the loan were in fact provided for in the transaction in which the property was sold. Next it appears that the borrowed money was not simply deposited in the partnership bank account to be used as the day-to-day exigencies of the business might require but was directly used to pay a part of the purchase price of the property itself, a property which was undoubtedly acquired as a revenue asset of the business. And in the ordinary course neither this money nor anything representing it would again fall into the hands of the partners or be capable of use by them in their business. Though in being used to purchase a trading asset it was used as circulating capital is used, it would not be used again in the way that circulating capital is ordinarily used over and over again. Nor did this borrowing expand or add anything of a permanent nature to the assets employed as capital in the business. I am accordingly of the opinion that the money so borrowed was not used as capital in the business in the sense in which the word "capital" is used in Section 12(1)(b) and that the bonus of $500 was not a payment or outlay on account of capital within the meaning of that clause. It follows that the bonus was properly deductible in computing the profit from the partnership business.

46 For completeness, I should mention that apparently, s 11(1)(cb) of the same legislation also provides that a taxpayer may deduct an expense incurred in the year in the course of borrowing money used by the taxpayer for the purpose of earning income from a business, but not any amount in respect of a bonus paid or payable to a person from whom the money was borrowed. Nevertheless, Thurlow J concluded that his opinion in respect of s 12(1)(b) regarding the Beatrice property was not affected by s 11(1)(cb).

47 As for the Cowan property, Thurlow J decided that the bonus was not deductible as he was of the view that the evidence did not show why the money was borrowed or what it was used for.

48 IA placed much reliance on Australian cases. For the time being, I need refer only to *Federal Commissioner of Taxation v Hunter Douglas Limited* 83 ATC 4,562 ("*Hunter Douglas*"). The taxpayer was in the business of developing, manufacturing and marketing window coverings and other building products. It borrowed money from overseas to finance the expansion of its business and to provide additional capital. The money was used to pay day-to-day running expenses. The loans could be drawn upon from time to time. The taxpayer claimed a deduction for exchange losses. Section 51 of

the Australian Income Tax Assessment Act 1936 (“ITAA”) states:

> 51.(1) 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.
>
> (2) Expenditure incurred or deemed to have incurred in the purchase of stock used by the taxpayer as trading stock shall be deemed not to be an outgoing of capital or of a capital nature.

49 The Supreme Court of New South Wales upheld the taxpayer’s claim. However, on appeal by the Commissioner, the majority of the Federal Court allowed the appeal as the purpose of the loan was capital in nature.

50 Fisher J said at 4,569 and 4,570:

> It is clear that the trial judge concluded that the exchange losses were on revenue account because of the use which the taxpayer made from time to time of drawings of the borrowed funds. …
>
> I however, regard the purpose of the borrowings as being of more assistance in establishing the character of the loan transactions and the exchange losses incurred on repayments thereunder and in determining whether they are on capital or revenue account. The use which a borrower in fact makes from time to time of borrowed funds and the purposes for which it applies them is not necessarily conclusive of the purpose or character of the borrowing. This character will depend upon the purpose for which the borrowing is made, e.g. to strengthen the capital structure of the company and also the use which the company makes *generally* of borrowed funds in its profit-earning activities. The crucial question will frequently be whether the company uses the borrowed funds to finance its profit-earning activities or as an integral part of such activities. …
>
> The purpose of the borrowings was to finance the expansion of the taxpayer’s business and to provide the additional working capital which this expansion required. Thus the borrowing transactions themselves were not on revenue account. Furthermore the funds borrowed were not used in or as an integral part of the profit-making activities of the taxpayer, i.e. as part of the process by which it operated to obtain its regular returns, but in the financing of such activities. In particular they were undertaken with a view to expanding such activities.
>
> These borrowings may in fact have been used to pay the day-to-day expenses, or in reimbursing a bank account from which such expenses were paid. However in my opinion this does not determine conclusively the part that borrowed funds played in the profit-making activities of the taxpayer or the true character of the loan transactions. The words of Mason J. in the *CAGA* case (*Commercial & General Acceptance Ltd. v. F.C. of T.* 77 ATC 4375; (1977) 137 C.L.R. 373) are in point. He said at ATC p. 4381; C.L.R. p. 384:
>
>> No doubt the effect of the loan was to enable the taxpayer to divert other funds into the more profitable channels of its finance business, but this does not affect the character of the loan transaction itself.

51 Lockhart J said at 4,575:

> The essence of the business of a finance company is the borrowing and lending of money. Its borrowings provide funds which it turns over at a profit by lending the moneys borrowed at a higher rate of interest than is payable on the moneys which it borrows. A finance company generally borrows money for the purpose of increasing its working or circulating capital which it turns over at a profit. It deals in money. The money which it turns over by borrowing and lending is similar to trading stock. As was pointed out by the majority of the High Court in the *Avco* case (at ATC p.4258; A.L.J.R. p.677) there are obvious differences between the "money stock" of a finance company and the trading stock of a trading company: money is not dealt with in specie as a commodity and is not included in the definition of trading stock for the purposes of the Act (see sec.6). But there is a close similarity between the borrowing and lending of money by a finance company and the buying and selling of trading stock by a trading company.
>
> Where a trading company buys goods which it turns over as trading stock gains or losses incurred are of a revenue nature. If moneys payable by a taxpayer are allowable deductions, in general any increase or decrease in those amounts caused by fluctuations in the exchange rate are likewise allowable deductions or assessable income as the case may be. If a trading company borrows money overseas in circumstances where the borrowing is a necessary part of and has the purpose of purchasing trading stock exchange gains or losses will be revenue items.

He said at 4,576:

> The essential question, when ascertaining the nature of foreign exchange gains or losses made on repayment of moneys borrowed, is to determine the purpose of the borrowing. In my view the use to which borrowed moneys are put is merely evidentiary of the purpose of those borrowings and not conclusive of it. …
>
> Borrowing money to carry on business must prima facie be treated as augmenting the capital employed in the business. Borrowings by finance companies to then lend to their customers, and borrowings by trading companies to finance the purchase of trading stock, are exceptions to this general rule. Such borrowings are an integral part of the ordinary conduct of the company's business and are thus revenue, not capital, items. Moneys borrowed by a finance company are turned over by making loans to its customers. Moneys borrowed by a trading company for the purpose of financing the purchase of trading stock are borrowed with a view to disposal of the stock at a profit. They are in each case part of the company's circulating capital.
>
> Borrowings are prima facie part of a company's fixed capital. The distinction is between the capital which enables a business enterprise to be conducted and the activities by which the income of the business is earned.

At 4,577 he concluded:

> The principal purpose of the borrowing in this case was to strengthen the business structure or organisation of the taxpayer to enable it to provide a stronger base or entity with which to carry on its business and earn profit. The nature of the borrowings determines the nature of the foreign exchange losses for fiscal purposes. As the former were capital items so were the latter.

52 The dissenting judge Franki J said at 4,565:

> The exchange losses in the case before us were an integral part of the carrying on of the taxpayer's income-earning business and in my opinion ought to have been allowed as deductions under sec.51(1).

He said at 4,566:

> If it be necessary that exchange losses be of a recurrent nature then I am satisfied that the losses in this case are of a sufficiently recurrent nature to satisfy that requirement.

53 In the Southern Rhodesian case of *Commissioner for Inland Revenue v Genn & Co (Pty) Ltd* 20 SATC 113 ("*Genn*"), the taxpayer carried on the business of hardware and timber merchants. It purchased some of its stock-in-trade locally and also imported stock-in-trade. The taxpayer borrowed money on short term loans locally and paid a raising fee which was the difference between the interest rate payable and 10% per annum, the latter being the overall interest the taxpayer was prepared to pay. The Commissioner for Inland Revenue allowed the deduction of interest on the loans but not of the raising fee. Section 11(2)(a), of the Southern Rhodesian Act 31 of 1941 states:

> (2) The deductions allowed shall be
>
> > (a) expenditure and losses actually incurred in the Union in the production of the income, provided such expenditure and losses are not of a capital nature.

54 The Appellate Division of the Supreme Court of the Union allowed the raising fees to be deducted. Schreiner JA said at 119:

> It should I think be observed at the outset that, whatever might be the position on other facts, it is not possible in the present case to justify a difference in treatment between the interest on the loans and the commissions; the circumstances mentioned above show that in each case the commission together with the interest formed in effect one consideration which the company had to pay for the use of the money for the period of the loan. Although, therefore, the commissioner allowed the deduction of the interest, as distinguished from the commission, the principles to be followed are on the present facts equally applicable to both.

He continued at 120 to 122:

> In giving the judgement of this Court in *New State Areas Ltd. v. Commissioner for Inland Revenue*, 1946 A.D. 610, the same learned Judge, then Chief Justice, referred at 620 to the distinction between floating and fixed capital and said,
>
> > When the capital employed in a business is frequently changing its form from money to goods and vice versa (e.g. the purchase and sale of stock by a merchant or the purchase of raw material by a manufacturer for the purpose of conversion to a manufactured article), and this is done for the purpose of making a profit, then the capital so employed is floating capital. The expenditure of a capital nature, the deduction of which is prohibited under section 11(2), is expenditure of a fixed capital nature not expenditure of a floating capital nature because expenditure which constitutes the use of floating capital for the purpose of earning a profit, such as the purchase price of stock-in-trade, must necessarily be deducted from the proceeds of the sale of the stock-in-trade in order to arrive at the taxable income derived by taxpayer from that trade. The problem which arises when deductions are claimed is, therefore, usually whether the expenditure in question, should properly be regarded as part of the cost of performing the income-earning operations or as part of the cost of establishing or adding to the income-earning plant or machinery.
>
> In deciding how the expenditure should properly be regarded the Court clearly has to assess the closeness of the connection between the expenditure and the income-earning operations, have

regard both to the purpose of the expenditure and to what it actually effects.

…

Interest paid on money borrowed and used for the purposes of a business would appear to be expenditure actually incurred in the production of the income of the business, whether the loan was for the acquisition of fixed or floating capital. There might of course be the further question whether or not, because of its association with the fixed capital into which the loan is turned, interest on such a loan may not properly be said to be expenditure of a capital nature. It is, however, unnecessary to pursue that question since in the present case the facts found by the Special Court show that the expenditure by way of interest or its equivalent was to meet a continuous demand for the means of acquiring the company's stock-in-trade, that it was not aimed at augmenting the fixed capital or maintaining an enduring asset of the company, but that on the contrary it was directed towards and achieved a relatively rapid turnover of the company's floating capital, with the object and effect of gaining a profit. …

55 In the South African case of *Commissioner for Inland Revenue v General Motors SA (Pty) Ltd* 43 SATC 249, ("*General Motors SA*"), the taxpayer was a wholly-owned South African subsidiary of General Motors Corporation of the United States of America ("USA"). It wanted to deduct exchange losses in respect of four loans to it. The Commissioner disallowed the deduction. On appeal to the Special Court, the losses for three of the loans were allowed. The Commissioner appealed to the Provincial Division and there was no cross-appeal in respect of the fourth loan. The Commissioner's appeal was dismissed. Section 11(a) of the South African Income Tax Act 58 of 1962 states:

For the purposes of determining the taxable income derived of any person from carrying on any trade within the Republic there shall be allowed as deductions from the income of such person so derived –

(a) expenditure and losses actually incurred in the Republic in the production of the income provided such expenditure and losses are not of a capital nature.

56 In respect of the three loans:

(a) The first loan was in German currency and was from General Motors Overseas Capital Corporation of the USA. It was dated 27 December 1968 and was for a period of one year renewable for one or more successive periods of one year each, but not beyond November 1976. The purpose of the loan was to pay for trading stock purchased by the taxpayer from various General Motors "source" plants.

(b) The second loan was an overdraft facility in sterling. It was granted by Barclays Bank International London between March 1972 and February 1973 for the payment of loans by sister companies which were "source" plants of General Motors Corporation or for direct payment of stock from "source" plants.

(c) The third loan was raised on 1 April 1975 in the currency of the USA. The lender was Irvine Trust Company New York and the loan was used to repay a loan owed to Lloyds Bank Ltd. The loan from Lloyds Bank Ltd was used in part-payment of another loan to the taxpayer, part of which was used to pay the second loan and part of which was used to pay loans by sister companies and therefore to pay "source" plants in respect of trading stock.

57 McCreath J said at 252 and 253:

I am in respectful agreement with the reasoning adopted by the learned Judge, in delivering the judgment of the Special Court, in his analysis of the principles laid down in the aforesaid cases. In regard thereto, the learned Judge states the following:

> 'The *Thiess Toyota* case [*Thiess Toyota (Pty) Ltd v Federal Commissioner of Taxation* 9 ATR 11] is illuminating and directly in point. There the taxpayer company held the Toyota Motor Sales Company of Japan's sole Australian franchise for the Toyota range of vehicles and borrowed money in order to import these vehicles, with a resultant gain – not a loss as in the instant case. It was submitted that the effect of the arrangement was that the taxpayer borrowed money from its bank to purchase its trading stock – and here I emphasise the phrase "borrowed money". It was argued that when it subsequently repaid its bank (the loan was in sterling which was devalued) it was a gain on capital account. The learned Judge discusses previous cases heard in various countries and particularly the *Commercial and General Acceptance Ltd v Federal Commissioner of Taxation* case 7 ATR 716 where it was said:
>
> > "I incline to think that an exchange gain or loss on the repayment of moneys lent will always be a capital gain or loss and can never be taken into account in the assessment of income."
>
> A study of the cases quoted indicates the rigid approach of previous years. Their logic, however, does not appeal to us and we prefer the approach adopted in *Thiess Toyota (Pty) Ltd* (*supra*) (and the two cases cited therein), namely that, in looking at the dealings of a manufacturer or trader, it is impossible to separate accurately the transactions into different juristic concepts, thereby virtually creating epithets for components of what is essentially one business dealing and attaching tax results to the various components. That, I would respectfully agree with Mears J in the *Thiess Toyota* case, is quite unreal. To my mind the logic of the situation, when applying the tests I have already quoted and which have been formulated in our law, demands that one should look at the substance and reality of the transaction and not at the juristic nature of the loan which eventually resulted. This is the approach adopted in the majority judgment in *Tip Top Tailors* [*Tip Top Tailors Ltd v Minister of National Revenue* 11 DLR 289] as well in the later case of *Cadbury-Fry Pascall (Australia) Ltd* [*Federated Commissioner of Taxes v Cadbury-Fry Pascall (Australia) Ltd* 10 ATR 55].'

By having regard to the 'substance and reality of the transaction' the Special Court was acting in accordance with the general tests which have been formulated by our courts and as defined by Watermeyer CJ in *New State Areas Ltd v Commissioner for Inland Revenue* 1946 AD 610 at 627 in the following terms:

> 'The conclusion to be drawn from all of these cases seems to be that the true nature of each transaction must be enquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset for the business, it is capital expenditure, even if it is paid in annual instalments; if, on the other hand, it is in truth no more than part of the cost incidental to the performance of the income-producing operations, as distinguished from the equipment of the income-producing machine, then it is revenue expenditure, even if it is paid in a lump sum.'

…

In the judgment of the Special Court Coetzee J went on to state the following:

> 'It is not contested on behalf of the Secretary that, when the facts of the first three loans are analysed, the substance and reality of these transactions point to the acquisition of trading stock for the purpose of deriving income therefrom. It satisfies the test laid down by Watermeyer CJ ("as distinguished from the equipment of the income-producing machine") which is, with respect, very happily framed, particularly when one has regard to the phraseology of Schreiner JA in the *Genn & Co (Pty) Ltd* case. Without wishing to add anything to terminology or nomenclature in these cases, I think that it may be useful to determine whether the expenditure is analogous to expenditure on what one might call the company's own "infrastructure", financially speaking, which is composed not only of fixed and tangible capital assets but also of assets of a monetary nature, which are usually permanent or semi-permanent. It seems that the first three loans were certainly not part of the company's infrastructure. Rather were they directly concerned with producing the revenue derived from the manufacture of the finished products from material obtained by appellant from "source" plants. The intervening loan exists purely and simply as a connection between the purchase of the trading stock or material and the production of the ultimate revenue and, to my mind, had nothing to do with the company's own infrastructure.'

I am in respectful agreement with the aforesaid remarks.

58 A number of Malaysian cases were raised in argument. In *K S Corpn v Ketua Pengarah Hasil Dalam Negeri* (1996) MSTC 2,677 ("*K S Corpn*"), the taxpayer was part of a consortium invited to tender for a port expansion project in Sabah. The taxpayer's tender was accepted. It was required to arrange a financial package to finance the project so that the Sabah Port Authority ("SPA") would need to make payment only after completion of the project. The financial package included a local loan and advances from Japan. The SPA's obligation to pay was in two portions, one denominated in ringgit and the other in yen. When the SPA paid the yen portion, the taxpayer received a gain in view of the fluctuations in the relevant exchange rate. The taxpayer claimed that this gain was an accretion to capital and not assessable to tax. The Special Commissioners decided it was part of revenue and taxable, after citing, *inter alia*, Lockhart J's judgment in *Hunter Douglas* and Rand J's judgment in *Tip Top Tailors Ltd v Minister of National Revenue* 11 DLR 289 with approval.

59 In *FCD Sdn Bhd v Ketua Pengarah Jabatan Hasil Dalam Negeri* (1995) 2 MSTC 2,181 ("*FCD*"), the taxpayer was a housing developer. It had purchased a piece of land to build a multi-storey building, the Menara Apera-ULG, to be sub-divided into offices which were to be sold. The taxpayer obtained a syndicated loan for the construction costs. The loan was guaranteed by a finance company and an insurer to whom the taxpayer paid a guarantee fee semi-annually. The question was whether the guarantee fees were deductible. Section 39 of the Malaysian Income Tax Act 1967 ("Malaysian ITA 1967") states:

> 39(1) Subject to any express provision of this Act in ascertaining the adjusted income of any person from any source for the basis period for a year of assessment no deduction from the gross income from that source for that period shall be allowed in respect of:
>
> …
>
> (b) any disbursements or expenses not being money wholly and exclusively laid out or expended for the purpose of producing the gross income.
>
> …

and which but for this paragraph would be deductible in ascertaining the adjusted income from the business.

39(2) It is hereby declared that sec. 33 except in so far as it relates to expenses of the kind specified in subsec. (1)(a) to (d) thereof, is not an express provision of this Act within the meaning of this section.

60 Section 33 states:

(1) Subject to this Act, the adjusted income of a person from a source for the basis period for a year of assessment shall be an amount ascertained by deducting from the gross income of that person from that source for that period all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of gross income from that source, including:

(a) subject to subsec. (2), any sum payable for that period (or for any part of that period) by way of interest upon any money borrowed by that person and –

(i) employed in that period in the production of gross income from that source; or

(ii) laid out on assets used or held in that period for the production of gross income from that source … .

61 The Special Commissioners said:

(9) Generally speaking, expenditure which relates to the acquisition of a source of income or a capital asset would be of a capital nature. On the other hand expenditure relating to the performance of profit earning operations would be of a revenue nature. Some of the more important tests that are applied to distinguish capital expenditure from revenue expenditure are whether an asset of an enduring nature has been created, whether the expenditure is referable to fixed or circulating capital, whether it is an initial outlay, whether it is to acquire goodwill or a right to earn profits and the type of business being carried on by the taxpayer.

…

(14) It was argued this [*sic*] the guarantee fee was for augmenting the Appellant's capital. That might well have been so if indeed it had no other intentions or plans for the land but instead was minded to sit tight holding it for example as mere investment. In that event, it would have been comparable to the *Beauchamp's* case. Land here significantly is an integral part of its stock-in-trade and the development of the office complex its prime intention throughout as stated by its witness (AW1). This was further borne out by the way that the Appellant's accounts were maintained. It owned the land and has some working capital but not quite enough to meet the entire cost of its office complex project, so it had to borrow as well. Borrow it did but not without certain conditions having to be met such as interest, commitment fees and guarantee fees.

As regards interest, this is explicitly allowed (as deduction) by sec.33(1) and thus is not disputed by the Respondent. Commitment fee although not claimed was allowed under sec.33(1) then [*sic*] Respondent implicitly had accepted the fact that the loan was wholly and exclusively incurred during that period in the production of gross income! But that was not quite so apparently going by the Respondent's stand in the present case!!

(15) The nub of the matter at issue centres around the answer to this key question: Would any financing institution grant such a massive loan to the Appellant embarking upon a major project of a "lumpy" nature, with no proven track record behind it and inadequate assets to act as collateral but for the guarantees from reputable and creditworthy institutions? In this respect, it also accords with the then and still current practice in the property development business for loan funds to be deployed both for acquiring landed properties for development and for financing construction costs pending revenues being generated through sale proceeds of completed structures. …

…

(19) Similarly in coming to a determination in the present case whether or not guarantee fees are allowable deductions under sec.33(1) as revenue expenditure, it is vital for and indeed incumbent on this Court to assess all relevant circumstances and take due cognisance of the accepted prevailing practices of *modus operandi* in the property development business in Malaysia: that it is a common practice to borrow to finance stock-in-trade which to a property developer comprises both landed properties earmarked for development and building materials and the like required for construction work. Significantly the major portion ($31m out of $36m) of the loan for which three years of first drawdown). The pattern of drawdowns totalling $26.8m was also all within a relatively short time span on 27 months (Exh. P1). Revenues were also generated in quick order as the floors in the 20-storey office complex were completed and sold and gains obtained to effect prompt repayments to the lenders. All these factors point to the loans being necessary to meet solely the vagaries of the business of property developer particular in acquiring stock-in-trade, but not to augment capital and create an enduring asset as contended by the Respondent. In the event, the payment of guarantee fees without which the loan [*sic*] not have been a practical proposition cannot but rank as an ordinary incident in the property development business.

(20) Indeed the nexus linking all the three – interest – guarantee fee – commitment fee – is so integral to the loan package in that they represent different facets of the loans so crucial and critical to the realisation of this income through the timely completion of each of the 20 floors of the office complex.

(21) If interest expense was already acknowledged as wholly and exclusively incurred in producing the income, surely guarantee fees which not only stand on the same footing with interest and commitment fee but on a much stronger ground and justification and enumerated above must inevitably come within the opening paragraph of sec.33(1).

According to another Malaysian judgment (*infra*, [63]), the decision of the Special Commissioners in *FCD* was upheld by the High Court.

62 In *Ketua Pengarah Hasil Dalam Negeri v Seabanc Kredit Sdn Bhd* (1998) MSTC 3,695 ("*Seabanc*"), the taxpayer was a finance leasing company. It obtained bank loans between 1982 to 1989 to carry on its business. In doing so, it incurred various fees like loan processing, loan management, guarantee, facility, arrangement and commitment fees. It also incurred stamp fees. The question was whether these fees were deductible under s 33(1) of the Malaysian ITA 1967. The Special Commissioners allowed these expenses but the High Court did not. Nik Hashim bin Nik Ab Rahman J said at 3,699:

With respect, I do not agree with the contention. The principle in the *Avco* case is not quite relevant and applicable to the present case. The expenses incurred in this case were made essentially with a view to bringing into existence the money, i.e. the asset, through the loan. The obtaining of the loan is a step preparatory to the earning of income, and therefore the expenses are not wholly and exclusively incurred in the production of income. Further, the loans were not taken on a frequent basis. Based on the agreed facts (Exh. A) the respondent took loans in 1982, 1983, 1984 and in 1989. From 1985 to 1989 (a period of four years) the respondent did not take any loan at all. These loans were fixed loans. This indicates that the loans taken constitute additions to the capital employed by the respondent, and it does not matter whether they were intended to be employed in the making of payments of a revenue of a capital nature (see *Beauchamp v. F.W. Woolworth* (1989) STC 510). Therefore, the expenditures incurred in obtaining the loans are capital in nature, and hence not deductible under sec.33(1). The expenses so incurred by the respondent were not wholly and exclusively incurred in the production of gross income. Such expenses are caught by sec.39(1)(b) of the Act, and hence, not allowable deduction.

I should add that in *Seabanc*, the learned judge did not refer to the decision of the Special Commissioners in *FCD*.

63 In *Fernrite Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* (2004) MSTC 4,065 ("*Fernrite*"), the taxpayer was an investment holding company. It had entered into an agreement to purchase shares and warrants in Perbadanan Nasional Berhad ("PNB"). Upon completion of the agreement, the title in the shares and warrants were transferred to it but payment of the purchase price was deferred until 12 months after completion. The taxpayer obtained the facility of a bank guarantee to secure payment of the purchase price. It made quarterly payments of commission for the use of the facility. As events turned out, the deadline for payment was deferred for another 12 months and the facility was also extended for another 12 months. In the meantime, the taxpayer received dividends for the two years in question from its purchase. The question which arose was whether the bank commissions were deductible from the dividend income under s 33 of the Malaysian ITA 1967. The Special Commissioners decided they were not deductible. On appeal, the High Court decided that they were deductible. Dato Faiza Tamby Chik J was of the view that the Special Commissioners had erred in concluding that the bank guarantee was a precondition for the purchase price of the shares and warrants. He criticised the decision in *Seabanc* and concluded at 4,085:

> Dividend income accrued from purchase of the shares and warrants and it follows that the operating cost of producing the income should be allowed. As was said in the Court of Appeal case of *ML & 2 Ors* (supra) interest on loans is tax deductible. Bank Commission is analogous to interest and falls within the meaning of wholly and exclusively incurred in the production of income. At any rate the bank commission cannot be described as capital since it is recurring expenditure and does not add to the cost of the shares and warrants but to the cost of earning the dividend income. Further, it cannot be said that the bank commissions were for the purchase price paid in instalments over a period of time. There is no evidence to support such a conclusion. … It is also an agreed fact that the bank commission fees are for use of the Bank Guarantee; not to create it.

He also noted at 4,076 that the decision of the Special Commissioners in *FCD* was upheld by the High Court in *Ketua Pengarah Hasil Dalam Negeri v FCD* case number RI 14-3-1993.

64 I should add that in *Fernrite*, the taxpayer did not seek to deduct the arrangement fees from the dividend income. This is what the learned judge said at 4,075:

> While the bank commission was annual and thus recurring, the "arrangement fees" was paid once and for all. The Appellant does not dispute that "arrangement fees" is capital since it is

preparatory to the bank guarantee but disputes the respondent's not allowing the bank commissions, which are recurring, and thus a revenue expenditure.

65 In Singapore, Chao Hick Tin J (as he then was) had noted in *Andermatt Investments Pte Ltd v Comptroller of Income Tax* [1995] 3 SLR 451 ("*Andermatt*") that there were differences between s 51 of the ITAA and our s 14(1)(*a*). He said at 457, [15]:

> The facts of none of these cases are near to the present case. Moreover the wording of relevant Australian provisions (s 51) are not in *pari materia* with the Singapore provision. There are, *inter alia*, these two areas of differences. First, in Australia, a taxpayer's gross income has to be ascertained before deductions are allowed whereas in Singapore deductions are allowed on each and separate source of income of the taxpayer. In other words there has to be a matching of expenses against each individual source under the Singapore law. In Australia this is not required. Expenses which generate income can be deducted against the cumulative income of the taxpayer. Second, under the Australian Act in view of the words 'to the extent to which they are incurred' it is clear that the losses and outgoings are apportionable, which does not appear to be possible under our law. Therefore, we think the Australian cases should always be considered bearing the differences in mind.

66 As can be seen, Chao J was merely sounding a word of caution when Australian cases are considered. This caution was reiterated by the Court of Appeal recently in *JD Ltd v Comptroller of Income Tax* [2005] SGCA 52. However, unlike the Board in the case before me, Chao J did not suggest that Australian cases on income tax are generally of low persuasive value. Indeed, in *Andermatt*, Chao J did subsequently refer to some other Australian cases, which I shall come to later, without apparent demur.

67 Moreover, in *T Ltd*, Ang JC had preferred the approach of the High Court of Australia in *Steele v DFC of T* 99 ATC 4,242 to that of the approach of the Privy Council in *Wharf* with regard to the issue as to whether interest was a deductible expense. However, that part of Ang JC's decision is confined to interest only and does not purport to cover the other types of expenses that are comprised in the Relevant Expenses. I would add that Ang JC did not eschew the focus on the purpose of the loan.

68 While it is true that in Australia there is a statutory provision in s 51(2) of the ITAA to stipulate that expenditure incurred in the purchase of stock used as trading stock "shall be deemed not to be an outgoing of capital or of a capital nature", the trading stock principle is also recognised in jurisdictions where there is no such statutory provision. In Southern Rhodesia, *Genn* is an illustration although it is true that the loans there were of a shorter duration. In South Africa, *General Motors SA* is an illustration. In Malaysia, *FCD* is an illustration. Also, Lockhart J's judgment in respect of financing for the purchase of trading stock in *Hunter Douglas* was cited with approval in the Malaysian case of *KS Corpn*.

69 In Singapore, the *Singapore Master Tax Guide Manual* (CCH Tax eds) (1989, 2001 release) also refers to expenditure on trading stock as being deductible and an English case is cited for this proposition. The text states at p 2804, para 1010:

> (d) *Expenditure relating to fixed capital* — if the expenditure relates to circulating capital, ie stock in trade, it will rank for deduction. It will not if it relates to fixed capital, ie fixed assets. The distinction between fixed and circulating capital is that fixed capital is what the owner turns to profit by keeping it in his possession; circulating capital is capital which is turned over, and in the process of being turned over, yields profit or loss (*John Smith & Sons v Moore* 12 TC 266).

70 The concept of circulating and fixed capital is also recognised in various jurisdictions. In Southern Rhodesia, *Genn* is again an illustration. In Canada, *Silverman* is an illustration. Even in England, *John Smith & Sons v Moore* is an illustration. In *Beauchamp*, the Special Commissioners referred, at para 15 of the case stated, to the distinction between fixed and circulating capital. They considered it relevant only when items of expenditure are under consideration whereas in *Beauchamp*, exchange losses were under consideration.

71 Coming back to the Australian position, IA was relying on *Hunter Douglas* not only because of the trading stock principle, but also because *Hunter Douglas* had focussed on the purpose of the loan. To that extent, *Hunter Douglas* was not inconsistent with *Wharf* where the Privy Council also focussed on the purpose of the loan. This was unlike *Beauchamp* which focussed on whether the loan was of a temporary and fluctuating nature. Accordingly, Hoffman J's statement at 293 that "No one can describe a loan for a fixed term of five years as a mere temporary accommodation" must be seen in that context.

72 I should point out that s 16(1)(a) of the IRO refers to "sums payable … by way of interest upon any money borrowed … for the purpose of producing such profits". In other words, "purpose" is specifically used in the Hong Kong legislation whereas it is not in s 14(1)(*a*) of the ITA. Nevertheless, that was not the stated reason of the Privy Council for focussing on the purpose of the loan in *Wharf*. Indeed, in the case before me, CIT considered s 16(1)(a) of the IRO to be *in pari materia* with our s 14(1)(*a*).[note: 1]

73 In so far as the Board was of the view that *Wharf* had decided that a loan taken up to purchase trading stock does not ordinarily lead to it being a revenue loan unless it is temporary and fluctuating[note: 2], it seems to me that the Board had misinterpreted Lord Hoffmann's judgment which stated at 512:

> Ordinarily, however, a loan to a trading company, whatever the purpose for which it is intended to be used, will be an addition to that company's capital.

There was no reference in that sentence to a loan for the purchase of trading stock. In any event that sentence focuses on the intended use of the loan. In the next paragraph, Lord Hoffman referred to the purpose of the loan as being critical (*supra*, [33]).

74 In so far as the Board preferred the decision in *Bridgwater* on the basis that its facts were identical to those in the present case, I am of the view that there was, with respect, hardly any analysis in *Bridgwater*. The focus was on whether the loan was of a temporary nature and the court simply concluded that there was evidence to support the decision of the Special Commissioners that the loan was not of a temporary nature.

75 As for the Board's reliance on *Beauchamp* and *Wharf*, I have mentioned that the focus in *Beauchamp* was whether the loan was of a temporary and fluctuating nature. Some cases refer to the latter as the recurrence of the loan. Such reasons would have been wanting in *Wharf* where each loan was for a short duration and renewed from time to time. It was then that the Privy Council decided to focus instead on the purpose of the loan as I have mentioned. IA does not quarrel with the proposition that the court should consider the purpose of the loan and indeed it relies on this proposition to advance its case. I will come back to the purpose of the Syndicated Loan later.

76 The Board also relied on *Bennett,* but in that case, the Supreme Court of Canada was of the view that the loan was for a general purpose, *ie* to purchase equipment and generally to finance the

operations (see the judgment of Locke J at [35]) and the court also focussed on the duration of the loan (see the judgment of Estey J at [36]).

77 As for the Malaysian cases, the Board did not follow *FCD* for the following reasons. First, the Board considered that too much reliance was placed on the practice of developers. Secondly, the Board was of the view that it might not be logical to adopt the reasoning behind the deductibility of interest expenses for the deductibility of guarantee fees since interest is a specific deductible. Thirdly, the Board was of the view that the reasoning of the Special Commissioners, in not following the English decisions, was unclear as those decisions were not discussed. Fourthly, *FCD* was inconsistent with *Seabanc*.

78 Although the Board pointed out that it was not disputed in *Seabanc* that the taxpayer was dealing in money and money was its trading stock, I note that the court in *Seabanc* focussed instead on the duration of the loan and the point that the loan was not taken on a frequent basis. Indeed, the court chastised the Special Commissioners for being preoccupied with the issue of trading stock and the court did not give weight to the purpose of the loan. Although the decision in *Seabanc* was about one year after *Wharf*, the court there did not refer to *Wharf* and instead relied on *Beauchamp*.

79 As regards the point in *Seabanc* that the obtaining of the loan was a step preparatory to the earning of income, I am of the view that that is too sweeping a statement. If that is correct, then all loans will never be revenue in nature as even loans for the purpose of earning income are in that sense preparatory to the earning of income. Indeed, such a proposition would exclude expenses on loans to those who deal in money as a business from being deducted, although the English cases recognise that for such businesses, the expenses will be deductible if the loan is temporary and fluctuating.

80 As for *Fernrite* disagreeing with *Seabanc*, the Board declined to follow *Fernrite* as it did not refer to the leading English authorities and instead went on to discuss Australian authorities. The Board then considered that the Malaysia cases were of low persuasive value.

81 I should mention that although IA was relying, *inter alia*, on *Fernrite*, probably because *Fernrite* disagreed with *Seabanc*, the court in *Fernrite* had taken into account the fact that the commission there was of a recurring nature. Furthermore, as I have mentioned, the taxpayer in *Fernrite* had not claimed a deduction for the one-off arrangement fees. Accordingly, it seems to me that *Fernrite* does not support IA's contention in respect of the Borrowing Expenses.

82 In any event, I am of the view that the Board had erred in focussing on the lack of temporariness and lack of recurrence of the Syndicated Loan. Such an approach does not take into account the different types of businesses. In the case before me, IA has developed one project only. The absence of recurrence of the loan is not determinative. The nature of a property developer's business is also such that a loan to it is not likely to be temporary but for a number of years. Furthermore, if the temporariness and lack of recurrence of the loan are the determinative factors, then the interest expenses in *Wharf* should have been considered as revenue and not capital. Would that then mean that if IA had managed to structure the Syndicated Loan for a much shorter duration but on a renewal basis, that would make a difference? I do not think the result should rest on such a foundation. As regards CIT's submission that the audited balance sheet of IA as at 30 September 1993 had described the Syndicated Loan as a non-current liability, I am of the view that this is only material if the temporariness of the loan is material.

83 The Board also noted that the amount of the Syndicated Loan was larger than IA's paid-up capital. It considered that the loan had enlarged IA's financial capacity to undertake a bigger project.

CIT had emphasized that the amount of the loan was larger than IA's capital. As the loan was also taken prior to the acquisition of the Land, which was part of its trading stock, the Board was of the view that the loan was similar to an injection of equity. The Board was also of the view that another indicator that the loan was more of an accretion to IA's capital was the fact that under the terms of the loan, IA was required to conduct its business in a certain manner. In particular, it was required to commence construction, obtain the temporary occupation permit and strata title, and meet certain sales targets by stipulated dates. The terms of the loan also set the minimum sales price of $420 per square foot.

84 I am of the view that the fact that the loan enlarged IA's financial capacity to undertake a bigger project or that the loan was of an amount larger than its capital is neither here nor there. Would it make a material difference if the amount of the loan was less than IA's capital? I do not think so. As was stated by the Special Commissioners in *FCD*, the Borrowing Expenses did not augment IA's capital. That might well have been so if IA was minded to hold the land as an investment. Here, the land was an integral part of its stock-in-trade. The fact that the loan was taken prior to the acquisition of the trading stock is also neither here nor there. The fact that the terms of the loan dictated certain conditions to the conduct of IA's business falls far short of the loan being akin to an injection of equity.

85 CIT also submitted that s 14(1) of the ITA allows a deduction of expenses incurred in the production of income "from any source chargeable with tax". CIT submitted that this does not allow expenses incurred prior to the existence of a source of income or prior to the commencement of business to be deducted. However, no authority was cited for this rather sweeping proposition. If CIT's submission was correct, then expenses incurred to acquire stock-in-trade like clothing before the commencement of business would also not be deductible.

86 The Board was also of the view that as the Land was developed and "converted" into approximately 1,100 apartments, it was not dealt with as trading stock *in specie* and hence the Borrowing Expenses were not revenue in nature. By "trading stock *in specie*", the Board appeared to mean the completed product as opposed to the raw material. The Board referred to *Thiess Toyota Pty Ltd v Federal Commissioner of Taxation* 78 ATC 4,463 ("*Thiess Toyota*") (which was also an Australian case) where the loan was to enable the taxpayer to buy and sell vehicles manufactured in Japan. However, I note that there was no suggestion in *Thiess Toyota* or in any other case that the loan must be to acquire trading stock *in specie* before its purpose can be considered as being revenue in nature.

87 Indeed, there are cases that suggest that the purchase of raw material for stock-in-trade would also be part of the purchase of stock-in-trade. For example, in *Genn*, Schreiner JA had cited with approval the judgment in *New State Areas Ltd v Commissioner for Inland Revenue* 1946 AD 610 where the purchase of raw material for the purpose of conversion to a manufactured article was mentioned as an example of floating (or circulating) capital. In *General Motors SA*, McCreath J had cited with approval the judgment of Coetzee J below where Coetzee J had said that the loans were concerned with producing the revenue derived from the manufacture of the finished products from material obtained by the taxpayer from "source" plants.

88 Furthermore, if the Board was correct that the loan must be to acquire trading stock *in specie*, that would mean that borrowing expenses for a loan to buy completed apartments for resale would be deductible but not borrowing expenses for a loan to acquire land for development and sale. I do not see why there should be a difference between the two as the land is just as much a part of trading stock as the completed apartments.

89 The stated and true purpose of the Syndicated Loan was to acquire the Land and also to pay for part of the development costs. The loan was used as such. As I mentioned at the outset, CIT had accepted before the Board, and initially before me as well, that the Land and the apartments were part of IA's trading stock. Therefore, it was not open to the Board to treat the Land as something else other than trading stock. The loan was an integral part of the profit-earning activities of IA. The Land was acquired not as an enduring asset to be kept in IA's possession but to be sold as part of common property with the apartments.

90 As the purpose of the Syndicated Loan was revenue in nature, the Borrowing Expenses were also revenue in nature and are deductible under s 14(1) of the ITA.

Prepayment Penalty

91 As regards the Prepayment Penalty, the Supreme Court of Victoria allowed a penalty for early payment to be deducted under s 51(1) of the ITAA in *Federal Commissioner of Taxation v Marbray Nominees Pty Ltd* 85 ATC 4,750 ("*Marbray*").

92 In the present case, the Board declined to follow *Marbray* partly because Australian legislation is different but primarily because the Board had concluded that the Syndicated Loan was a capital loan. The Board concluded that it naturally followed from the principle in *Beauchamp* and *Wharf* that all expenses related to the loan would be regarded as capital in nature. By that reasoning and in view of my conclusion that the purpose of the Syndicated Loan was revenue in nature, the Prepayment Penalty would also be revenue in nature.

93 I add that IA also relied on the English case of *Vodafone Cellular Ltd v Shaw (Inspector of Taxes)* (1997) STC 734 ("*Vodafone*"). In *Vodafone*, the taxpayer had entered into an agreement with one of its shareholders to pay an annual fee for technical know-how for 15 years. It transpired that the technical know-how was not needed. The taxpayer agreed to pay a sum of US$30m to extinguish its liability under the fee agreement. The question which arose in respect of that sum was whether it was deductible under s 130(a) of the ICTA which precluded the deduction of any sum in respect of any disbursement or expense, not being money wholly and exclusively laid out or expended for the purposes of trade. The Court of Appeal decided that the sum was deductible. Millet LJ said at 739:

> Two matters are of particular importance: the nature of the payment, and the nature of the advantage obtained by the payment. The fact that the payment is a lump sum payment is relevant but not determinative. In a case such as the present, where the payment is made in order to get rid of a liability, a useful starting point is to inquire into the nature of the liability which is brought to an end by the payment. Where a lump sum payment is made in order to commute or extinguish a contractual obligation to make recurring revenue payments then the payment is prima facie a revenue payment.
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> In *Hancock (Surveyor of Taxes) v General Reversionary and Investment Co Ltd* [1919] 1 KB 25, 7 TC 358 the payment of a lump sum in order to commute an annual pension was held to be an income payment because it merely anticipated payments which if not commuted would have been income payments. In such a case the lump sum might be regarded as of the same nature as the ingredients of which it was composed (see *Van den Berghs Ltd v Clark (Inspector of Taxes)* [1935] AC 431 at 442, 19 TC 390 at 431 per Lord Macmillan).
>
> In *Anglo-Persian Oil Co Ltd v Dale (Inspector of Taxes)* [1932] 1 KB 124, 16 TC 253 the payment of a lump sum in order to secure the cancellation of an agency agreement which was onerous to the principal and would otherwise have endured for a further ten years was held to be a revenue

payment. Lawrence LJ said ([1932] 1 KB 124 at 141, 16 TC 253 at 270) it –

> '… neither enlarged the area of its operations, nor improved its goodwill, nor embarked upon a new enterprise; it merely effected a change in its business methods and internal organisation, leaving its fixed capital untouched.'

> But the principle that a payment made in order to commute or discharge a liability to make recurring revenue payments is itself a revenue payment is subject to an important qualification. If the liability to make recurring revenue payments is reduced or brought to an end by the modification or disposal of an identifiable capital asset, then any payment made for the modification or disposal is itself a capital payment.

94 He also said at 742:

> The principles derived from the foregoing survey of the authorities are sufficient to satisfy me that the fee agreement was not a capital asset, that it was a liability but only because it was likely to entail a heavy drain on the annual income of the taxpayer company, and that by cancelling it the taxpayer company did not obtain an enduring benefit for its trade in the sense in which that expression is used in this context.

95 Applying *Marbray* and *Vodafone*, the Prepayment Penalty should also be deductible under s 14(1) of the ITA. However, CIT submitted that by incurring the Prepayment Penalty, IA had secured a release from its contractual obligations under the Syndicated Loan and thereby interest savings which constituted an enduring benefit. As in *Vodafone*, I am of the view that such benefits are not the kind of enduring benefit in the sense in which that expression is used.

96 As for CIT's submission that the Condo Project could be developed without incurring the Prepayment Penalty, that is not the point. There was a loan to be repaid and that loan was needed to purchase the Land and pay part of the development costs. The loan attracted the recurring liability to pay interest. The Prepayment Penalty was incurred to avoid paying further interest.

97 Accordingly, I am of the view that the Prepayment Penalty is revenue in nature and deductible under s 14(1) of the ITA.

Guarantee Expenses

98 It is not disputed that IA would have used the progress payments from the sale of apartments to pay the Syndicated Loan directly but for the statutory requirement that such proceeds have to be deposited into a project account. In order to obtain the release of $100m from the progress payments, IA obtained bank guarantees for an equivalent amount. In so doing, IA incurred the Guarantee Expenses.

99 As regards *Vodafone*, the Board was of the view that it was distinguishable on its facts as the fee agreement there was a revenue item. However, as I have concluded that the purpose of the Syndicated Loan was revenue in nature, this point of distinction is unavailable. Nevertheless, the Board relied on, *inter alia*, *Harrods (Buenos Aires), Ltd v Taylor-Gooby (HM Inspector of Taxes)* (1964) 41 TC 450 ("*Harrods*"), *Tata Hydro-Electric Agencies, Limited, Bombay v Income Tax Commissioner, Bombay Presidency and Aden* [1937] AC 685 ("*Tata*") and *The Madras & Southern Mahratta Railway Co Ltd v Commissioners of Inland Revenue* (1926) 12 TC 1,111 ("*MSMR*") which the Board considered to be more on point than the first two cases mentioned above. I will deal with these cases in chronological order.

100 In *MSMR*, the taxpayer had entered into a contract with the Secretary of State for India to construct and operate a railway on land owned by the Secretary of State. The taxpayer raised capital from the public which had a guaranteed interest from the Secretary of State. Under the contract, the profits in operating the railway were divided between the Secretary of State and the taxpayer. From the taxpayer's share, the Secretary of State recouped the amount he had to pay under the guarantee. The question arose whether the profits of the taxpayer for the purpose of Corporation Profits Tax was the amount before the Secretary of State recouped that amount or the balance after recoupment. Rowlatt J decided it was the former and rejected the argument that the liability to make good the amount of the guarantee had diminished the taxpayer's share of the profits. He considered the recoupment as being a distribution of profits as the recoupment depended on the amount of the profits. With respect, I do not agree with the Board's view that *MSMR* is a case more on point. The facts there were quite different.

101 In *Tata*, the taxpayer was the managing agent of various electric supply companies including Tata Power Co Ltd, having taken over the agency from Tata Sons, Ltd. Tata Sons, Ltd had been under an obligation to pay 25% of its commission from Tata Power Co Ltd to two parties who had provided financial assistance to Tata Power Co Ltd. The taxpayer had taken over this obligation, *ie* to pay over 25% of its commission to the two parties. The question which arose was whether the taxpayer could deduct a sum representing the 25% commission for the purpose of computing its tax liability. The Privy Council decided that that sum was not deductible as the obligation undertaken by the taxpayer was in consideration of its acquisition of the right and opportunity to earn profits and not for the purpose of producing profits in the conduct of the business. In my view, the facts in *Tata* are different from those before me.

102 In *Harrods*, the taxpayer was incorporated in the United Kingdom but carried on business of a general store in Buenos Aires, Argentina. It was liable to a tax under Argentine law known as the substitute tax. The question was whether the taxpayer was entitled to deduct the amounts it paid under that tax in computing its profits for the purpose of tax under the law of the United Kingdom. The Court of Appeal decided that the amounts the taxpayer paid under the substitute tax were deductible. Accordingly, it seems to me that the Board had erred in thinking that the conclusion in *Harrods* was the same as that in *Tata*. In any event, the Board relied on the judgment of Danckwerts LJ who said (*Harrods* at 467):

> There are a number of authorities upon the question of deductible expenses and the guiding principle appears to me to be that if the expense has to be incurred for the purposes of gaining the company's profits, it is a deductible expense; on the other hand, if the payment of the expenses or charges is made after the profits have been ascertained, then the expense is not deductible, because it is simply an application of the profits which have been earned.

103 The above-quoted passage from Danckwerts LJ's judgment can support the argument which CIT had raised before the Board, and which the Board accepted, that the Guarantee Expenses were not incurred in the period in which the income was earned as the income had already been earned. It will be recalled that s 14(1) of the ITA states that for the purpose of ascertaining the income "for any period …, there shall be deducted all outgoings and expenses wholly and exclusively incurred during that period …". However, in IA's appeal before me, CIT did not seek to rely on this argument anymore as, in practice, CIT has never applied the section in this manner[note: 3]. I would add that the facts in *Harrods* are also different from those before me.

104 Interestingly, the Board had observed that in *Andermatt*, Chao J had said, at 460, [27], that under s 14(1)(*a*) of the ITA, "there must be a direct link between the money borrowed and the

income produced". Yet, in the next sentence in *Andermatt*, Chao J noted that there was such a direct link in the Australian case of *Federal Commissioner of Taxation v Roberts & Smith* 92 ATC 4,380 ("*Roberts & Smith*"), a case which the Board declined to follow as it had considered Australian cases to be of low persuasive value because of the different legislation.

105 In *Roberts & Smith*, a firm of solicitors had obtained a loan to enable its partners to withdraw part of their capital in the firm. The question was whether the interest paid on the loan was deductible under s 51(1) of the ITAA. The Full Federal Court decided it was deductible. Hill J said at 4,388:

> For example, let it be assumed that there are undrawn partnership distributions available at any time to be called upon by the partners. The partnership borrows from a bank at interest to fund the repayment to one of the partners who has called up the amount owing to him. That partner uses the moneys so received to purchase a house. A tracing approach, if carried beyond the payment to the partner, encourages the argument raised by the Commissioner in the present case that the funds were used for the private purpose of the partner who received them. But that fact will not preclude the deductibility of the outgoing. The funds to be withdrawn in such a case were employed in the partnership business; the borrowing replaces those funds and the interest incurred on the borrowing will meet the statutory description of interest incurred in the gaining or production by the partnership of assessable income.
>
> In principle, such a case is no different from the borrowing from one bank to repay working capital originally borrowed from another; the character of the refinancing takes on the same character as the original borrowing and gives to the interest incurred the character of a working expense. Both these cases would equally satisfy the second limb of s.51(1). In no sense could the interest outgoing in either case be characterised as private or domestic. Similarly, where moneys are originally advanced by a partner to provide working capital for the partnership, interest on a borrowing made to repay these advances will be deductible, irrespective of the use which the partner repaid makes of the funds.

106 In *Federal Commissioner of Taxation v Jones* 2002 ATC 4,135 ("*Jones*"), the taxpayer had refinanced a loan and the question was whether the interest paid on loans after the cessation of business was deductible under s 51 of the ITAA. The primary judge decided it was deductible. His reasons are stated at 4,137:

> The appellant points to nothing other than the cessation of the partnership business as justifying the assertion that such payments were thereafter not deductible. It is said that the cessation of business resulted in a break in the relevant nexus, but the cases seem to suggest otherwise. The obligation undertaken whilst carrying on the business was to repay principal and interest. That obligation having been undertaken in the course of earning assessable income and for that purpose, it seems to follow that the interest payments on such borrowings continued to be outgoings incurred as contemplated in subs 51(1) until some event or circumstances arose to break the necessary nexus, cessation of the business of the partnership not necessarily being sufficient for such purpose.
>
> As is observed in some of the cases, the passage of a substantial period of time after the cessation of business may be relevant to the question but not necessarily conclusive. In such cases passage of time may lead to the inference that the taxpayer has kept the loan on foot for reasons unassociated with the former business. … These are not the circumstances of the present case. It is clear from the findings of the Tribunal, and it is consistent with the way in which the case has been conducted that the respondent has not been in a position to repay the

loan, although she has been attempting to do so as best she can from the resources available to her. This demonstrates that the failure to repay the loan over the quite lengthy period since her husband's death is attributable to her financial position and not to any decision to keep the loan on foot for other reasons.

107 The Full Federal Court upheld this decision. They said at 4,141:

> We agree with his Honour that the refinancing in May 1996 did not break the nexus between the interest expense and the business. It is well established that when an original borrowing is refinanced, the new financing takes on the same character as the original borrowing. The character of the loan is not changed. See *FC of T v JD Roberts; FC of T v Smith* 92 ATC 4380 at 4388; (1992) 37 FCR 246 at 257 and *FC of T v The Midland Railway Co (WA) Ltd* (1952) 9 ATD 372 at 377; (1951 – 1952) 85 CLR 306 at 313. All that happened in the present case was that the identity of the borrower changed and the rate of interest was lower. The taxpayer was financially unable to repay the ANZ loan without taking out another, and this she did in order to obtain a more favourable rate of interest. In all respects the new borrowing with [*sic*] referable to the same "occasion" as its predecessor. …

108 Section 51 of the ITAA is different from s 14(1)(*a*) of the ITA in that the latter specifically provides that interest payable on capital employed in acquiring income is deductible whereas the former has no such specific provision. Yet, in *Roberts & Smith* and *Jones*, the interest was considered to be deductible.

109 There are other differences between the Australian legision and the ITA as noted by Chao J in *Andermatt* (see [65] above). Nevertheless, in my view, those differences do not diminish the persuasive weight of *Roberts & Smith* and *Jones* on the issue relating to the Guarantee Expenses. Indeed, *Roberts & Smith* was one of the Australian cases which I had said at [66] above that Chao J had cited without apparent demur. Furthermore, as I mentioned above at [104], Chao J was of the view that *Roberts & Smith* was a case where there was a direct link between the money borrowed and the income produced, unlike the facts before him in *Andermatt*. I would add that as the Board did not place reliance on the facts in *Andermatt*, which were different from those before me, I do not propose to elaborate on such facts here.

110 In *Rakyat Berjaya Sdn Bhd v Ketua Pengarah Hasil Dalam Negeri* (1999) MSTC 3,731 ("*Rakyat Berjaya*"), the first loan obtained by the taxpayer was to pay royalties in ringgit currency. The taxpayer obtained a second loan from the same bank in US currency to finance working capital requirements and investments in project. The taxpayer had wanted to take advantage of foreign exchange benefits. The second loan was used to pay the first loan. The Inland Revenue accepted that interest on the first loan was deductible under s 33(1)(a) of the Malaysian ITA 1967. However, it contested the deductibility of interest on the second loan. The High Court of Sabah and Sarawak decided it was deductible. Charles Ho J said at 3,735:

> To my mind what is of real importance is that the second loan was fully used to pay off the first loan. In the circumstances and the undisputed facts in this case, I agree with counsel for the appellants that the second loan should be considered as a replacement loan or refinancing. It follows, as a matter of logic and common sense that since interest payments on the first loan were deductible (conceded by Revenue) because they fall within the provisions of s 33(1)(a) of the Act, interest payments on the second loan would also be deductible for income tax purposes.

However, the Board distinguished *Rakyat Berjaya* on the basis that there, the second loan was exactly of the same character as the first loan.

111 In my view, while it is true that there was, strictly speaking, no second loan as such in the present case, the bank guarantees nevertheless constituted a second facility. They still amounted to a refinancing which enabled the release of funds to pay the Syndicated Loan. In the circumstances, I do not see why the nature of the second facility should make a difference. The main components of the Guarantee Expenses were based on interest calculations as well. Although the business of IA has abated, if not stopped altogether, that should make no difference in view of *Jones* and also CIT's concession that it was not using the argument that the expenses must be incurred in the same period when the income is earned.

112 I now come to a case which CIT relied on although the Board did not rely on it for the Guarantee Expenses issue. In *Montreal Coke*, the taxpayer had financed its business by money borrowed from the public on interest-bearing bonds. The principal and interest were payable at the bond-holders' option in US dollars. Owing to market conditions, the taxpayer decided to redeem the bonds and to issue new bonds at lower rates and less onerous conditions. The exercise incurred expenses which included a premature payment premium, an exchange premium as the existing bondholders elected to be paid in US dollars, commission to underwriters, interest on overlapping periods, and legal and printing expenses. The question was whether such expenses were deductible from income. The Privy Council decided they were not. Lord Macmillan said at 746:

> The question at issue turns entirely upon the terms of the Income War Tax Act, 1927. Part II of the Act, which is headed "Exemptions and Deductions," contains sect. 6 which has a sub-heading "Deductions from income not allowed." So far as relevant to the present purpose sect. 6 reads as follows:
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> > 6. In computing the amount of the profits or gains to be assessed, a deduction shall not be allowed in respect of (a) disbursements or expenses not wholly, exclusively and necessarily laid out or expended for the purpose of earning the income; (b) any outlay, loss or replacement of capital or any payment on account of capital or any depreciation depletion or obsolescence, except as otherwise provided in this Act.
>
> By sect. 9 of the Act the tax is charged upon income and by sect. 3 income is defined to mean annual net profit or gain.
>
> It is important to attend precisely to the language of sect. 6. If the expenditure sought to be deducted is not for the purpose of earning the income, and wholly, exclusively and necessarily for that purpose, then it is disallowed as a deduction. If the expenditure is a payment on account of capital it is also disallowed. The appellants say that the outlays in question were made wholly exclusively and necessarily for the purpose of earning income and were not payments on account of capital. The respondent maintains the contrary.
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> The justification for upholding the deductions claimed could not be more attractively presented than it is in the judgment of RINFRET, J (now Chief Justice of Canada), with which TASCHEREAU, J., concurred. The judge says:
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> > There are two ways of increasing the profits from a trade or commercial or other calling; either by increasing the earnings while the expenses remain the same or by decreasing the expenses while the earnings remain the same. Of course, if the expenses diminish at the same time as the gross earnings are increased the profits will be correspondingly larger and the proposition just mentioned is only made more evident … In order to pay a lower interest and to get rid of the exchange rates it was necessary to redeem the original bonds; and therefore the expenses required to achieve that result were wholly, exclusively and

> necessarily laid out or expended for the purpose of decreasing the fixed interest and exchange charges and accordingly "for the purpose of earning the income."

> Down to the last nine words quoted the statement of RINFRET, J., is unexceptionable, but their Lordships are unable to accompany him in leaping the last fence. If the statute permitted the deduction of expenditure incurred for the purpose of increasing income the appellants might well have prevailed. But such a criterion would have opened a very wide door. It is obvious that there can be many forms of expenditure designed to increase income which would not be appropriate deductions in ascertaining annual net profit or gain. The statutory criterion is a much narrower one. Expenditure to be deductible must be directly related to the earning of income. The earnings of a trader are the product of the trading operations which he conducts. These operations involve outgoings as well as receipts and the net profit or gain which the trader earns is the balance of his trade receipts over his trade outgoings. It is not the business of the appellants to engage in financial operations. The nature of their business is sufficiently indicated by their titles. It is to these businesses that they look for their earnings. Of course, like other business people, they must have capital to enable them to conduct their enterprises, but their financial arrangements are quite distinct from the activities by which they earn their income. No doubt the way in which they finance their businesses will or may reflect itself favourably or unfavourably in their annual accounts but expenditure incurred in relation to the financing of their businesses is not in their Lordship's opinion, expenditure incurred in the earning of their income within the statutory meaning. The statute in sect. 5(b) above quoted significantly employs the expression "capital used in the business to earn the income," differentiating between the provision of capital and the process of earning profits.

Section 5(b) of the relevant legislation there permits the deduction of "such reasonable rate of interest on borrowed capital used in the business to earn the income as the Minister in his discretion may allow".

113 However, it is also important to note that at 747, Lord Macmillan also said:

> It was conceded in the courts in Canada, and in any event it is clear, that the expenses incurred by the appellants in originally borrowing the money represented by the bonds subsequently redeemed were properly chargeable to capital and so were not incurred in earning income. If the bonds had subsisted to maturity the premiums and expenses then payable on redemption would plainly also have been on capital account. Why then should the outlays in connection with the present transactions, compendiously described as "refunding operations," not also fall within the same category? Their Lordships are unable to discern any tenable distinction. In the history of both companies the financial re-adjustment of their borrowed capital was an isolated episode, unconnected with the day to day conduct of their businesses, and the benefit which they derived was not "earned" by them in their businesses.

114 Accordingly, the earlier passage of Lord Macmillan's judgment must be read in the context that the original expenses were treated as capital in nature.

115 There is one other point I should mention. The Board was of the view that the repayment of the Syndicated Loan had in turn augmented IA's capital structure because IA was able to increase its unsecured loans to its holdings and to its ultimate holding company to the tune of several millions of dollars in the same year, but after the money in the Project Account was released, *ie* 1995. The Board was of the view that this supported the conclusion that the Guarantee Expenses were incurred not just to pay the Syndicated Loan but also to enlarge the permanent capital of IA.

116 I do not agree. In the illustration given by Hill J in *Roberts & Smith*, a loan may be used to repay a partner in a firm who then uses the money to purchase a house. That would not change the character of the repayment to him. In my view, the increase in the loans to the holding companies does not change the fact that the Guarantee Expenses were incurred to enable the repayment of the Syndicated Loan, the purpose of which was to acquire trading stock. The character of the repayment remains the same whatever else IA may have done as a consequence of the repayment of the Syndicated Loan. (See also the judgement of Mason J in the *CAGA* case cited in *Hunter Douglas*, *supra* [50]).

117 As I have concluded that the purpose of the Syndicated Loan was revenue in nature as it was to acquire trading stock, I am also of the view that the Guarantee Expenses are deductible under s 14(1) of the ITA.

Summary

118 In the circumstances, I allow the appeal of IA in respect of the Borrowing Expenses, the Prepayment Penalty and the Guarantee Expenses, all of which are deductible under s 14(1) of the ITA. The relevant assessments of CIT are reduced accordingly. CIT is to pay IA's costs of this appeal and of the hearing before the Board, which costs are to be agreed or taxed.

[note: 1]See para 105 of CIT's Case.

[note: 2]See paras 66 and 77 of the Board's grounds of decision

[note: 3]See para 265 of CIT's Case.