Deciphering deductions for borrowing costs

PwC Singapore Tax Bulletin – Deciphering deductions for borrowing costs

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The Income Tax Board of Review (the "Board") held that facility fees paid by the taxpayer in *GBG v The Comptroller of Income Tax* [2016] SGITBR 2 ("*GBG*") were not deductible on the grounds that they were capital in nature. The taxpayer did not seek a deduction under section 14(1)(a)(ii) of the Income Tax Act (the "Act") as there was no drawdown on the facilities and hence, no monies borrowed.

Background

The taxpayer carried on the business of ship and rig repair, building and conversion. In 2009, it secured three separate facilities (the "Facilities") for the purposes of funding capital expenditure, meeting general working capital requirements, general corporate funding, and as standby funds to finance any funding shortfall for its yard expansion project.

The taxpayer paid a total of $7,200,000 to three banks at the commencement of the Facilities. This was documented as "Front End Fee" in two of the agreements, and "Facility Fee" in the third (collectively referred herein as "Facility Fees"). The Facilities were available for drawdown within a specific period; however, as it turned out, the taxpayer did not drawdown upon the Facilities.

The taxpayer claimed deductions for the Facility Fees against its income for the Year of Assessment 2010, which the Comptroller disallowed. Dissatisfied, the taxpayer appealed to the Board.

Issues considered

The main issue arising in this Appeal is whether the Facility Fees incurred by the taxpayer are deductible under section 14(1) of the Act, and not prohibited from deduction as capital expenditure under section 15(1)(c).

The deductibility of the Facility Fees under section 14(1)(a) of the Act was not considered as there was no drawdown on the Facilities and the Facility Fees were therefore not a "sum payable in lieu of interest or for the reduction thereof…upon any money borrowed" .

The Board's findings

Guided largely by the approach laid down by the Court of Appeal ("CA") in *BFC v Comptroller of Income Tax*[1] ("*BFC*"), the Board first addressed the issue of whether the expense was capital in nature and thus prohibited from deduction under section 15(1)(c) of the Act. Following the principles set out by the CA in the two established decisions of *T Ltd v Comptroller of Income Tax*[2] ("*T Ltd*") and *Comptroller of Income Tax v IA*[3] ("*IA*"), the Board observed that, "…whether borrowing costs are capital expenditure or revenue expenditure depends on whether the loan in question

[1] [2014] 4 SLR 33
[2] [2006] SLR(R) 618
[3] [2006] 4SLR(R) 161

is capital or revenue in nature…"[4]. This is in turn determined by the purposes for which the loan was taken.

The Board rejected the taxpayer's argument that *IA* was not applicable to the case at hand given that there was no loan in existence. It was of the view that "…whereas the requirement for there to be actual borrowing is hardcoded in section 14(1)(a) ("upon any money borrowed"), this technical requirement is not encapsulated in the *ratio decidendi* of *IA"*. Commenting further on *IA*, the Board observed that it was "…plain and obvious to us that there was no complete drawdown of the facility undertaken by the taxpayer. This did not prevent the entire sum of the facility fee from being regarded by the courts as a borrowing expense…"

Applying the framework in *IA,* therefore, one would look to the nexus between the borrowing and the main transaction to which it relates to ascertain the purpose of the borrowing. The taxpayer asserted that at the time the facilities were entered into, the facilities could be used for any purpose. As none of the documented purposes had sufficient linkage to a main transaction that was of a revenue nature, the Board held that the facilities, and correspondingly the Facility Fees, were entirely capital in nature. This is consistent with the general principle that borrowing must *prima facie* be treated as augmenting the capital structure of the business, unless the borrowing was for a specific revenue purpose.

The Board went on to elaborate further that even if the *IA* case did not apply, the Facility Fees were clearly a capital expenditure falling within the scope of section 15(1)(c) of the Act on application of the composite framework set out in *ABD Pte Ltd v Comptroller of Income Tax* [2010] 3 SLR 609 ("*ABD*").

Firstly, the taxpayer submitted that the Facilities were taken as an anticipatory and precautionary measure to overcome or avert any possible adverse consequences of the global financial crisis. It followed that the purpose of the Facility Fees was to procure the Facilities to strengthen the taxpayer's capital structure, and not to save the taxpayer from an imminent catastrophe or destruction.

Secondly, all three banks required the payment of Facility Fees in a lump sum at the commencement of the Facilities. The Board was of the view that this manner of expenditure suggested that the Facility Fees are capital in nature.

Thirdly, the Board viewed that the consequence of the Facility Fees is to secure the option to tap on funds totalling $600 million, the purpose of which is to strengthen the capital structure of the business.

For these reasons, the Board held that the Facility Fees were capital in nature and hence deduction is prohibited under section 15(1)(c) of the Act. The appeal was accordingly dismissed.

PwC's observations

This appeal demonstrates the application of a series of recently established case law on the deductibility of interest expenses and other borrowing costs from *T Ltd* to *IA*

[4] *BFC v Comptroller of Income Tax* [2014] SGCA 39 at paragraph 29

and more recently *BFC*, and applies the framework for distinguishing capital from revenue expenses laid down in *ABD*.

Although not applicable to the facts in *GBG* as there was no drawdown, it is not difficult to tell the potential impact of the reasoning adopted in this decision on taxpayers. Where the actual use of the loans does not correspond with the stated purpose, the Inland Revenue Authority of Singapore (IRAS) and taxpayers are likely to find themselves engaged in protracted correspondence over how to demonstrate the purpose of the borrowings. While there is no doubt about the primacy of the purpose test in ascertaining the capital or revenue characterisation of a transaction, it should be noted that the actual use to which the borrowed funds is applied may well reflect that there could have been a change of purpose over time.

Further, this decision brings to the fore a fairly common issue, namely that the application of tax laws sometimes may not be keeping up with the realities of commercial practices.

The Board unequivocally concluded that the Facility Fees were part of the borrowing costs charged by the lenders. It observed that "[w]ithout the Facility Fees, the interest charged on any loans drawn down would have been higher", and asserts that the taxpayer had "...pre-paid part of the borrowing costs". The Board also took into consideration letters from the three lenders which made reference to the practice of "all-in" pricing of the Facilities, i.e. where the lenders regarded the facility fee and interest margin as the total price of borrowing.

This suggests a divergence between the deductibility provisions and ordinary commercial practices. Commitment fees are viewed as having been paid to the banker to stay "committed" to provide an agreed amount of loan. As there is no drawdown of the facility, there is no borrowing yet and hence such fees are not a substitute for interest expense and not deductible, but yet as shown in *GBG*, they are seen (and priced) as part of overall borrowing cost from a commercial perspective. The same treatment may potentially apply to other types of borrowing costs, such as option fees or interest rate cap premiums, which taxpayers may incur when taking up loan facilities. As such, a deduction is not available when there are no sums borrowed, unless the facility is taken for a revenue purpose (e.g. in connection with the purchase of trading stocks).

It should be noted that the list of prescribed borrowing costs has been extended from the Year of Assessment 2014 to include front-end fees, which are defined as "Any amount payable to the lender,...at the beginning...of the term of borrowing, which is equivalent to the interest which the borrower would otherwise be required to pay to the lender under the loan agreement", so if the loan is subsequently drawn down within the same year (thereby meeting the requirement under section 14(1)(a) that the expense is payable "upon any money borrowed"), a deduction should be allowed. That no deduction for commitment fee is available when there is no drawdown (or when the drawdown takes place in subsequent years) but that a deduction is given when there is one, when the commitment fee is, in reality, part of the overall borrowing cost appears to be incongruent application of tax policy on deduction for borrowing costs.

We suggest that the government could consider expanding the existing list of prescribed borrowing cost to cover such the upfront cost of securing standby facilities regardless of whether those facilities are drawn down. In addition to providing taxpayers with greater certainty, it would provide some relief to businesses in the current uncertain economic climate. Businesses which take up standby credit and similar facilities to better manage financing costs and cash flow in order to ensure they can sustain business operations would then be allowed to deduct those costs which may otherwise be viewed as capital in nature and hence not deductible.

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