Tax Alert
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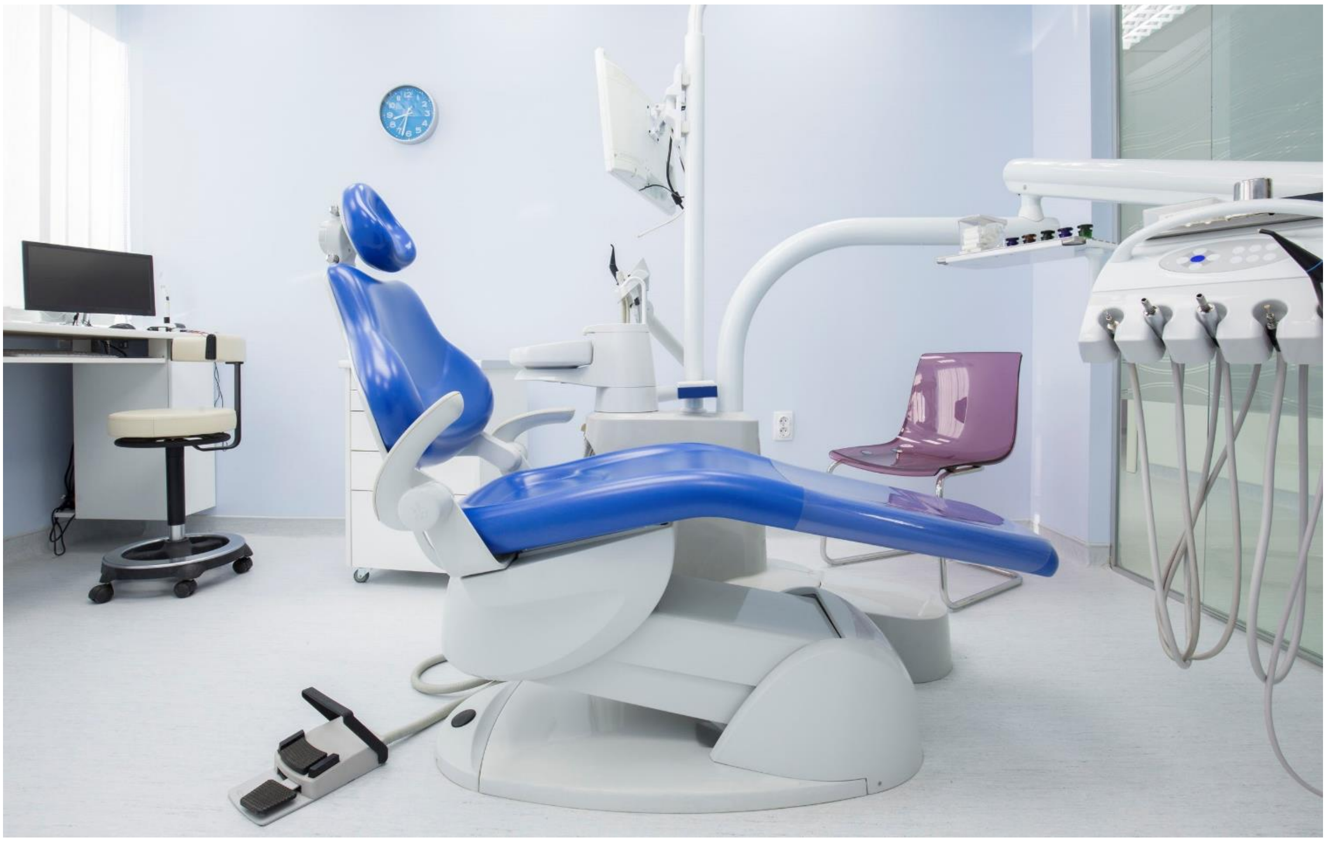
# Legitimate Corporatisation or Tax Avoidance?



**In the recent case of *GCL v Comptroller of Income Tax* [2020] SGITBR 1, a dentist had appealed against the Comptroller of Income Tax's decision to subject the income of his company to tax in his personal capacity. The appeal was however dismissed by the Income Tax Board of Review which upheld the decision of the Comptroller. In this issue of Tax Alert, we examine the case to glean further learnings.**

### Facts of the case

The taxpayer, GCL (an individual) is a registered dentist. He was earlier employed by YCO (an orthodontic clinic) to provide dental services to the patients of YCO.

In May 2012, GCL incorporated a company, XCO, of which he was the sole shareholder and director. At around the same time, YCO and GCL ceased their employer-employee relationship.

A service agreement was then put in place between XCO and YCO, pursuant to which XCO would provide dental services to YCO. XCO in turn procured its employee, GCL, to perform the relevant dental services at the clinic of YCO.

In return, YCO would pay a service fee to XCO which would in turn remunerate GCL for his services. The remaining profits of XCO would then be distributed as tax-exempt dividends to GCL in his capacity as the sole shareholder of XCO.

GCL provided various reasons for incorporating XCO in order to run his own dental practice. In particular, the incorporation and use of XCO as a business vehicle would fulfil the following:

- Facilitate the future expansion of the business.
- Ease the process of obtaining financing.
- Limit the business risk and liabilities to be borne by the owner.

Notably, there were plans for XCO to acquire a medical unit for its dental practice. The said medical unit was acquired about two years after the incorporation of XCO.

With regards to the remuneration received by GCL in his capacity as an employee of XCO, GCL explained that the amount was determined after taking into account his day-to-day expenditure, including payments for his housing and car loans.

GCL further explained that the profits of XCO were intended to be retained by the company to fund its operations. GCL was aware that the placement of XCO's retained profits as fixed deposits would give rise to taxable interest income if left in the hands of XCO, and that the same interest income would be tax exempt in the hands of GCL as an individual. With the above in mind, the profits of XCO were distributed as dividends to GCL (in his capacity as the sole shareholder of XCO), who in turn placed the funds as fixed deposits under his name. The funds which were set aside were eventually ploughed back into XCO to fund the purchase of the medical unit in 2017.

## The Comptroller's position

On the facts of the case, the Comptroller of Income Tax (Comptroller) was of the view that GCL had unduly derived a tax benefit and hence invoked the anti-avoidance provision under section 33 of the Income Tax Act (the Act) to assess the income derived by XCO, in the name of GCL.

In essence, the Comptroller disregarded the service arrangement in place between XCO and YCO, and imposed income tax on GCL in his personal capacity as though the previous employment arrangement between YCO and GCL was still in place.

The Comptroller's basis for this was that under the arrangement put in place following the incorporation of XCO, an artificially low level of remuneration was paid to GCL such that the 'remaining' profits of XCO could be paid to GCL as tax exempt dividends. Had GCL received the 'remaining' profits as a form of remuneration for his employment, such employment would have been taxable in the hands of GCL.

## Decision of the Board of Review

In arriving at the decision that the Comptroller was justified to invoke the anti-avoidance provision under section 33 of the Act, the Board of Review (the Board) dealt with various issues. These issues are discussed below.

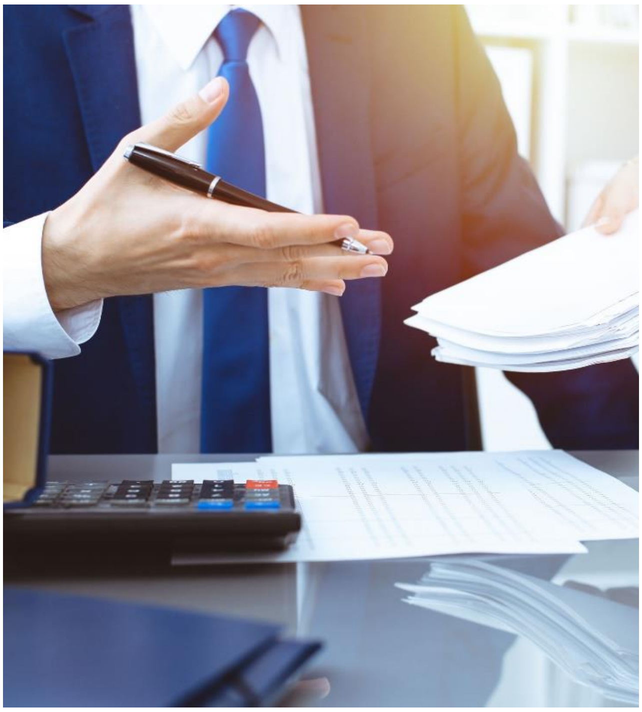
### – Incorporation of XCO

After considering the arguments put forth by the respective parties, the Board held that the incorporation of XCO to provide dental services does not in itself constitute tax avoidance.

In this regard, the Board observed that GCL's incorporation of XCO can be explained by reference to ordinary business norms and practices. More specifically, the use of a company to perform dental services is a common practice, and is not inherently an act of tax avoidance. Even though the income derived by a company may be subject to tax at a lower rate when compared to the highest marginal tax rate applicable to an individual, such an outcome is an inevitable consequence of tax policy.

### – Remuneration paid by XCO to GCL

With regards to the remuneration paid by XCO to GCL in his capacity as an employee of the former, the Board noted that the total remuneration was significantly lower than what GCL had earlier received from YCO, even though his role as a dentist had remained largely the same before and after the incorporation of XCO.



The Board was therefore of the view that there was no *bona fide* commercial reason for the artificially low remuneration arrangement post-incorporation of XCO, which had the effect of reducing the overall income tax liability when compared to the period prior to the incorporation of XCO.

The Board also agreed with the Comptroller's view that the intent of Parliament for the start-up tax exemption scheme and partial tax exemption scheme was to encourage the conduct of enterprise through a corporate structure, and that the arrangement put in place by GCL and XCO which sought to utilise these provisions for the avoidance of tax should not be considered to fall within the intent of Parliament.

The Board further noted that the transfer pricing provision under section 34D of the Act would in any case require GCL to be paid an arm's length remuneration by XCO. This was given that he, as the sole director and shareholder of XCO, exercised control over XCO.

## Our comments

### – Circumstances leading to the actions of the Comptroller

The highest marginal income tax rate applicable to income derived by individuals is currently 22%. In comparison, the rate applicable to income derived by companies is a flat 17%, with various avenues available to further reduce the overall effective tax rate – for example, under the start-up tax exemption scheme and partial tax exemption scheme.

The prevailing tax rate differential for individuals and companies was the result of deliberate polices of the Singapore Government over the years.

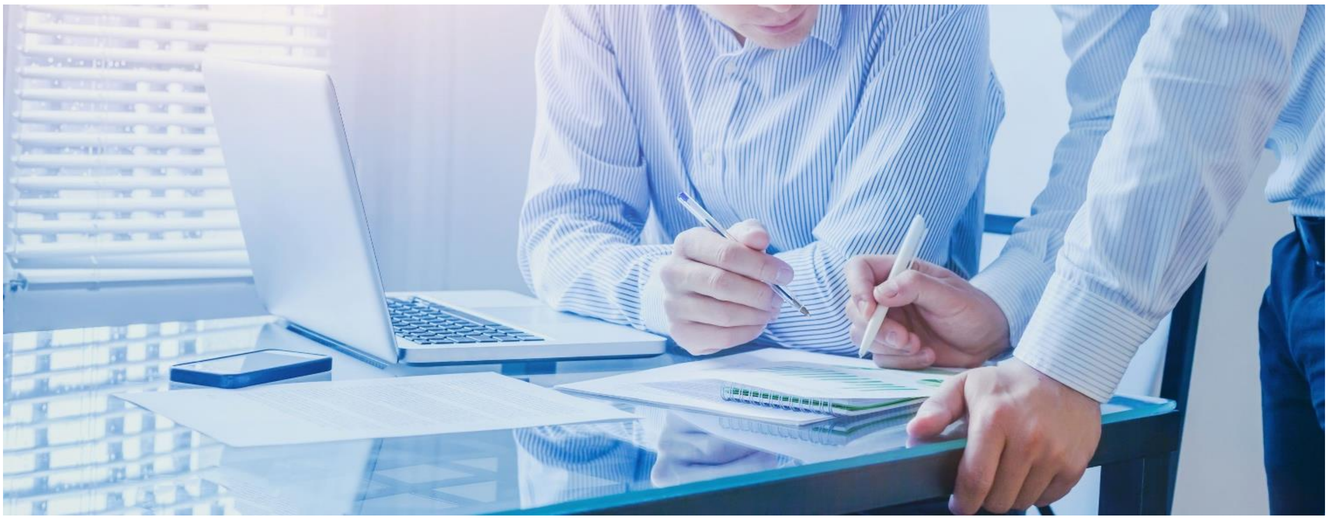
It may be recalled that slightly more than a decade ago, individuals and companies were facing the same headline tax rate of 20% for the Year of Assessment (YA) 2007. The tax rate applicable to income derived by companies was subsequently reduced to 18% in YA 2008 and further reduced to 17% with effect from YA 2010, in line with the trend of declining corporate income tax rates observed in many other jurisdictions.

As part of the Government's drive to increase the progressivity of the tax system, it was announced during the Budget 2015 speech on 23 February 2015 that the highest marginal tax rate for individuals would be increased from 20% to 22% with effect from YA 2017. This in turn meant that there would be a tax rate differential of at least 5 percentage points between the top income tax rate for individuals (at 22%) and the flat income tax for companies (at 17%).

Subsequent to Budget 2015, the then Senior Minister of State for Finance, Ms Josephine Teo, announced on 9 March 2015 that the Inland Revenue Authority of Singapore (IRAS) would be stepping up the monitoring of "corporatisation" trends that suggests that high-income earners are setting up companies to avoid higher income tax. In cases where it finds that the companies were set up for tax evasion[1], the tax authority would disregard the corporate structure and assess the individual based on his or her income. (Refer to '*IRAS to watch for tax evasion through corporatisation*', published by The Business Times on 9 March 2015)

Following the announcement by Senior Minister Teo, it was observed that there was indeed an uptick in the scrutiny of companies incorporated by high-income earners including doctors, anaesthetists and dentists.

It was against this backdrop that the Comptroller issued Notices of Additional Assessments to GCL on 15 February 2017, to impose tax on the service income derived by XCO and assess the tax in the name of GCL.



[1] The word "evasion" was used in The Business Times article. The word "avoidance" would have been more appropriate.

## – Having a tax benefit does not in itself imply that the transaction is tax motivated

Notably, the *GCL* case is the latest in a series of cases involving the application of the anti-avoidance provision under section 33 of the Act – the first being the landmark case of *AQQ v Comptroller of Income Tax* [2014] 2 SLR 847.

The case of *GCL* provided much needed assurance to high-income earners – and in particular, professionals – that the mere corporatisation of their previously unincorporated business should not in itself be regarded as tax avoidance.

In particular, the Board took a practical view that it would not be sufficient for the Comptroller to assert that an arrangement falls within section 33(1) of the anti-avoidance provision merely because the tax outcome of the arrangement was more favourable compared to that under the previous arrangement.

In this regard, we agree that it is critical to take into consideration the reasonableness of the actions undertaken (in this case, the incorporation of XCO). Otherwise, any restructuring that results in a more favourable tax outcome would always fall within the anti-avoidance provisions of section 33(1).

If an arrangement could be explained by referencing ordinary business dealings without necessarily being labelled as a means to avoid tax, then the said arrangement should not fall within the anti-avoidance provision at all.

## – The crux of the matter

In the present case, the appeal of the taxpayer was dismissed due to the inadequate level of remuneration paid by XCO to GCL in his capacity as an employee.

Had XCO paid an appropriate level of remuneration to GCL, taking into consideration the remuneration received by dentists with comparable skill and experience, it would seem that the outcome of the case might well be different even if the incorporation of XCO conferred any incidental tax benefits.

The Board was clearly unable to accept GCL's explanation that the tax-exempt dividends received from XCO were subsequently ploughed back into the company for the purposes of acquiring the medical unit to be used in its dental practice.

Having said the above, it is unclear whether the Board had adequately taken into account the fact that many start-ups typically pay their key employees a "sustenance" salary. Such a business practice may be attributed to the fact that there is no guarantee that the start-up would survive and thrive.

In many of these cases, the key employees may be awarded shares in the company as a performance-based incentive. These shares will constitute part of the employees' overall remuneration package. The gains derived from the holding of such shares (whether in the form of capital gains or dividends) are typically not taxed in the hands of these employees, given that the acquisition of the shares is not profit or trade motivated to begin with.

Following the Board's logic in deciding that GCL's incorporation of XCO is "capable of explanation by reference to ordinary business norms and practices", shouldn't the same be said of the "sustenance" level of salary paid by XCO to GCL?

In our view, the Board has not adequately articulated its reasons for taking the position that the arrangement of paying a low remuneration to GCL is "not capable of explanation by reference to ordinary business or commercial basis". Presumably, the Board had noted that XCO was profit-making for the relevant years. However, the Board made no specific mention of how it arrived at the conclusion that the low remuneration paid to GCL was not a *bona fide* commercial arrangement.

## – Personal exertion rule

Lastly, it is worthwhile noting that the Board rejected the Comptroller's argument that the income of XCO was in any case earned through the personal exertion of GCL, and therefore ought to be attributed to and taxed in the hands of the Appellant.

We agree with the position taken by the Board, as there is no provision in the Act which provides for the application of the "personal exertion" principle in Singapore. Accordingly, the Comptroller should not have the *carte blanche* to disregard the corporate vehicles set up by individuals and impose tax on the individual on such a broad principle, where the case on hand does not necessarily involve tax avoidance and/or non-arm's length transactions.

## How we can help

As your committed tax advisor, we welcome any opportunity to discuss the relevance of the above case to your business, as well as any transactions which your business may be contemplating.

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