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Genuine incorporation or tax avoidance?

LIU Hern Kuan

Vincent OOI
Singapore Management University, vincentooi@smu.edu.sg

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Some professionals have been incorporating one or more companies in an attempt to gain tax advantages.

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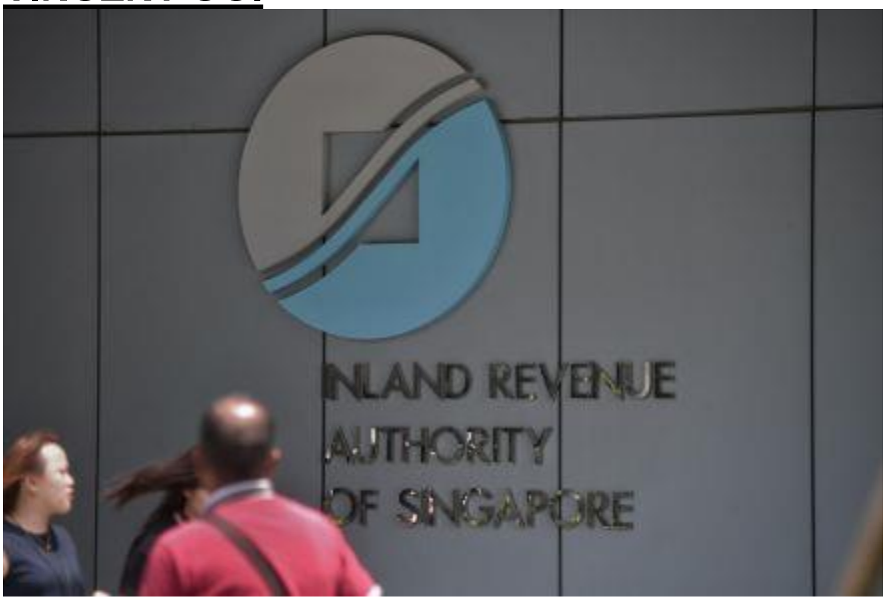
LIU HERN KUAN
VINCENT OOI



FOR the past few years, high-earning professionals such as doctors and dentists have been in the spotlight as the Inland Revenue Authority of Singapore (IRAS) intensified its investigations to uncover tax avoidance attempts.

In 2018, two articles in The Straits Times described how some professionals were incorporating one or more companies in an attempt to gain tax advantages. The issue was the difference between the highest personal income tax rate of 22 per cent and the corporate tax rate of 17 per cent, which provided an opportunity for tax arbitrage. The Start-Up Tax Exemption Scheme and Partial Tax Exemption and the availability of corporate tax rebates (typically announced during the Budget) also contributed to making incorporating one or more companies more attractive.

Since the articles were published, many professionals have attempted to justify their structures and arrangements to the IRAS, arguing that they were not engaged in tax avoidance. An article in BT ("Shining a light on tax avoidance," Nov 17, 2018) expressed our views on when an arrangement may be regarded as tax avoidance. While the IRAS has helpfully provided guidance to medical professionals on this, many questions regarding the law in this area remained. The line between permissible tax planning and tax avoidance was arguably unclear; and in many cases, it was no easy task to determine whether there had in fact been tax avoidance.

In the recent case of GCL v Comptroller of Income Tax, the Income Tax Board of Review (ITBR) laid down several principles that may help clarify the legal position here. The case is a very significant one as it addresses head-on several important questions about professionals incorporating companies and tax avoidance. We caution that none of our comments is intended to be taken as legal advice and that, especially in the context of tax avoidance, cases often turn on very specific facts. Nevertheless, it may be useful to look at the GCL case.

The salient facts of the case are as follows. In GCL the taxpayer, a dentist, was employed by Yco, an orthodontic clinic, and was paid a market rate salary for dental services rendered by him. He incorporated a company, XCo with himself as sole director and shareholder. He then resigned his employment with YCo; and in his place, XCo entered into a service agreement with YCo, where dental services were provided by XCo to YCo. The services were in fact provided by the taxpayer, who treated patients at YCo's premises. YCo would pay service fees to XCo. X Co would then pay dividends and a salary to the taxpayer.

The Comptroller of Income Tax (CIT) regarded the income earned by XCo to be that of the taxpayer's and imposed tax on the taxpayer on an individual tax basis. The CIT's view was that the taxpayer, by incorporating and providing services through XCo, was involved in tax avoidance.

The ITBR ruled that the setting up of a company to provide services and receive service income was not by itself, tax avoidance. However the remuneration received by the taxpayer from XCo was significantly low and constituted tax avoidance.

The reasoning of the ITBR is important: the ITBR accepted that the test for tax avoidance may, very generally, be broken down into two parts. It is first necessary for the CIT to first establish that there is an arrangement that would produce a tax advantage. In this first part, the predication principle must be applied. If, applying the predication principle there is tax avoidance, then the analysis proceeds to the second part: the taxpayer must show that the arrangement was carried out for bona fide commercial reasons and did not have, as one of its main purposes, the avoidance or reduction of tax. Crucially, the first part of the test is objective in nature (in that the actual motives of the relevant persons are generally not to be considered) and the second part, subjective.

For the first part, the "predication principle" states that if an arrangement is objectively capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax, then it is not a case of tax avoidance. The significance of GCL is this: Professionals may be relieved to know that the ITBR held that the use of a company to carry out a dental practice is a common and widely used set-up, not inherently a tax avoidance arrangement. Thus, incorporation of a professional practice to carry out a profession is not, in itself, capable of constituting tax avoidance.

In GCL, as the ITBR found on the first part of the test alone that there was no tax avoidance, strictly speaking, it did not need to consider the second part of the test. However, it helpfully provided guidance on this issue, stating that it found that the taxpayer's reasons for incorporation (facilitating future expansion of the business, the potential ease in obtaining financing and the limitation of business risk and liabilities) are natural benefits of operating a business in an incorporated entity and would constitute bona fide commercial reasons. It is noted that the test here is a subjective one, and depends on the intentions of the particular taxpayer at the point of incorporation.

While incorporation alone may not be sufficient to constitute tax avoidance, the ITBR held that the lower salary paid to the taxpayer after incorporation was tax avoidance. The taxpayer's work was largely the same before and after incorporation. (It will be recalled that before incorporation he provided dental services under his employment with YCo; after incorporation, he provided services through XCo).

However, on the level of remuneration received by the taxpayer from XCo, the taxpayer conceded that his remuneration was based on his personal upkeep and maintenance requirements. The lower salary after incorporation thus effectively reduced his tax liability. The ITBR therefore ruled that this arrangement could not be explained by reference to ordinary business or commercial basis, and the taxpayer was unable to establish that the lower salary had been paid for bona fide commercial reasons.

ARM'S LENGTH TRANSACTION

The ITBR noted that as the taxpayer was the sole director and shareholder of the company he incorporated, section 34D of the Income Tax Act would require that he was to be paid an arm's length salary by the company. "Transactions not at arm's length" are those made between related parties whose terms differ from those which would have been made had the parties not been related. In such cases, the "arm's length" price may be used to recalculate the taxable profits. So in GCL, the arrangement to pay the taxpayer a lower salary constituted tax avoidance. The same arrangement would have also fallen foul of the arm's length principle, had the CIT chosen to invoke that provision.

The CIT also argued that the "personal exertion principle" originating from New Zealand law would apply to tax the income received by XCo in the hands of the taxpayer. The "personal exertion principle" provides that income from personal exertion should accrue to the natural person and cannot be assigned or diverted to another person, such as a company. The ITBR made it clear that this principle has no basis in Singapore tax law, and should not be applied in Singapore as well.

In summary, the GCL case has provided some much needed clarity on what constitutes tax avoidance. Professionals will now be better able to ensure that their business operations are structured in a manner that does not constitute unacceptable tax avoidance. Specifically, while professionals can incorporate companies with which to conduct their businesses, they must be careful not to pay themselves an artificially low salary.

- **The writers are from Tan Peng Chin LLC. Liu Hern Kuan is head of tax at the law firm; he was previously the chief legal officer of the Inland Revenue Authority of Singapore for 10 years. Vincent Ooi is an associate at the firm and a lecturer at the Singapore Management University (SMU) School of Law. The views are the writers', and do not represent those of Tan Peng Chin LLC or SMU.**