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12-2020

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Citation

LIU, Hern Kuan and OOI, Vincent. Artificially low salaries and tax dodging. (2020). *Business Times*.
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Artificially low salaries and tax dodging

The case of Wee Teng Yau v Comptroller of Income Tax sheds light on issue of professionals setting up an incorporated company and tax avoidance.

WED, DEC 16, 2020 - 5:50 AM

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IN THE recent case of Wee Teng Yau v Comptroller of Income Tax, the Singapore Supreme Court considered the issue of tax avoidance by professionals for the first time. The case involved a dentist, Dr Wee, who was initially employed by Alfred Cheng Orthodontic Clinic Pte Ltd (ACOC). Subsequently, he incorporated Straighten Pte Ltd (SPL), of which he was the sole director and shareholder. Dr Wee continued to provide the same dental services to ACOC's patients as he had done before. However, instead of paying Dr Wee directly for his services, ACOC paid for his services to SPL, which in turn paid Dr Wee a salary and a director's fee.

The remuneration paid by SPL to Dr Wee was significantly lower than the salary he used to receive from ACOC. Additionally, tax-exempt dividends were also declared and paid by SPL to Dr Wee. Thus, as a result of the new arrangement, the total tax liability would be lower due to the tax benefits under the Start-Up Tax Exemption Scheme and the tax rate differential between the Corporate Income Tax Rate and the Personal Income Tax Rates.

The Comptroller of Income Tax (CIT) was of the view that this arrangement constituted tax avoidance and sought to recover the tax advantages enjoyed by Dr Wee. The Comptroller's position was upheld by both the Income Tax Board

of Review (ITBR) and the High Court. The Court concluded that the arrangement helped Dr Wee to reduce his tax liability and was indeed tax avoidance.

The judgments of the ITBR and the High Court in this case help shed some much-needed light on the question of what turns an innocent business arrangement into a tax avoidance arrangement.

Setting up a company for 'a compendium of purposes'

Both the ITBR and the High Court agreed that there could be a variety of legitimate reasons for a doctor to incorporate a company through which he could render his medical services. In the words of the High Court, "doctors who set up private limited companies with a compendium of purposes such as delegating the management of the business and limiting the liability of the doctors are not the sort of arrangements contemplated in s33 (the anti-avoidance provision)".

It is worth noting that the question of whether a company is incorporated for legitimate purposes is, in the first instance, to be assessed objectively. In other words, the question is whether a reasonable person would conclude that the company was incorporated for tax avoidance purposes. It is not relevant at this stage what the actual motives were for incorporating the company and what the doctor, who incorporated the company, actually intended.

However, even if a reasonable person concluded that a company was incorporated for tax avoidance purposes, a professional can still refute this conclusion by showing that there were bona fide commercial reasons for the arrangement and that it did not have, as one of its main purposes, the avoidance or reduction of tax.

'Personal exertion' concept does not apply in Singapore

While ACOC paid SPL for Dr Wee's services, the CIT had argued that income received by SPL for Dr Wee's services should accrue to Dr Wee and that SPL should not be regarded as having earned the income. The Comptroller's position was that income from personal exertion should accrue to the natural person whose exertions generated the income, and the income cannot be assigned or diverted to another person, such as a company (the "personal exertion principle").

This argument was rejected by both the ITBR and the High Court on the basis that generally, there was no specific provision under the Income Tax Act that

could permit the CIT to attribute the income of a company to an individual. Thus, it is clear that the concept of "personal exertion" does not apply in Singapore.

The High Court went on to state that the concept of "personal exertion" may merely be a "judicial expression that was intended to emphasise the fact that a person cannot avoid paying taxes for work done by him, simply by assigning his pay to someone else".

It is certainly true that the mere transfer of income to someone else cannot, in itself, also transfer the tax liability for such income along with it. Tax on the income is borne by the person who earned the income - before the income is transferred. Upon transfer of the income to the recipient, the question is whether the transferee of the income is subject to tax on the income received by way of the transfer.

In other words, the tax liabilities of both the transferor and transferee of the income are generally considered separately. However, the personal exertion principle conflates the position of both transferor and transferee of the income.

We illustrate this point using the analogy of a subcontracting model where the main contractor has to carry out certain work but sub-contracts the work to a sub-contractor. The sub-contractor carries out the work through his personal exertions.

The "personal exertion" of the sub-contractor on the work does not change the fact that the sub-contractor is only entitled to the remuneration stated in the sub-contract with the main contractor. The sub-contractor's tax position is to be considered separately from the main contractor's tax position. The sub-contractor cannot be taxed based on the full payment made to the main contractor for the work done, but only on the amounts received under the sub-contract. There is no "assignment" of income and tax liability here, despite the "personal exertion" of the sub-contractor in carrying out the work.

Paying an artificially low salary can constitute tax avoidance

Both the ITBR and the High Court found tax avoidance primarily on the fact that Dr Wee's remuneration paid by SPL was significantly lower than the salary he used to receive from ACOC, although he provided the same dental services to ACOC's patients as before.

The significance of the artificially low salary is twofold. Firstly, paying an artificially low salary and declaring the rest as dividends enabled Dr Wee to receive the same amount of income as he previously did from ACOC, but with reduced tax liability. Thus, objectively speaking, a reasonable person would

think that SPL was incorporated for tax avoidance purposes. Secondly, an inference could be drawn that Dr Wee did not carry out the arrangement for bona fide commercial reasons and that tax avoidance was one of the main purposes of the arrangement.

In this case, it was clear that Dr Wee had paid himself an artificially low salary, since he received a much lower remuneration after the arrangement, despite performing essentially the same services. However, it may not be quite so clear in other cases as to what constitutes an artificially low salary.

With respect to this, the CIT has suggested in a circular that an acceptable salary can be determined through market salary benchmarking, or a cost-plus methodology. Under the first method, the salary paid would not be artificially low if it was in line with what other comparable professionals were receiving. Under the second method, the CIT has indicated that it would generally accept an arrangement where the company could have a markup of 10 per cent of its costs for specialist medical services and 15 per cent for dental services or general practitioner services, with the remaining profits to be paid to the medical professional. The Comptroller has also stated that it would accept other justifiable markup margins or bases of apportionment.

Conclusion

Professionals should bear in mind that while they may incorporate companies through which they practise for legitimate reasons, they must be able to justify the amount of remuneration received. Artificially low salaries are unlikely to stand up to scrutiny by the tax authorities and the courts.

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