

Tax Bulletin

AQP v Comptroller of Income Tax

December 2011

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Commercial crimes make frequent headlines these days and reports of the misuse of company funds are not uncommon. A curious question arises as to whether losses suffered by the company from such a defalcation are tax deductible. The principles behind this were discussed in *AQP v Comptroller of Income Tax*,¹ where the High Court decided that a loss incurred due to a director's defalcation is not tax deductible. The case also shed light on what constitutes an error or mistake within the meaning of section 93A of the Income Tax Act (the "Act").

How it all came about

The taxpayer company, AQP, distributes bearings and seals. It was listed on the Singapore stock exchange in 1995. C was appointed the managing director in the same year. In December 1999, C was dismissed for misappropriating company funds. C was investigated by the Commercial Affairs Department, charged for criminal breach of trust and sentenced to prison. The trial revealed that C had misappropriated company funds to pay off his gambling debts. Among other things, he would make out false purchase orders to AQP's suppliers and be reimbursed by AQP on his claim that he had advanced money from his personal account for the purchases.

After the misappropriation was made known, AQP made a provision for doubtful debts of \$12.3m in its statutory accounts for the financial year ended 31 December 1999. No deduction was claimed in its tax return for Year of Assessment 2000. In 2003, AQP took legal action against C to recover the money lost but it proved irrecoverable. In 2005, AQP lodged an "error or mistake" claim for its loss of \$12.3m under section 93A of the Act.² The Comptroller of Income Tax rejected the claim. AQP appealed to the Board of Review, which decided in favour of the Comptroller. (Because the amount was decided to be not deductible, the Board of Review did not think it necessary to decide whether there was an error or mistake within section 93A of the Act. In passing, however, it commented that AQP's omission to claim a deduction for the loss, had it been a mistake of law, would qualify as an error or mistake within section 93A, provided the loss had been deductible.) AQP appealed to the High Court, where the case was dismissed.

The seminal case on the issue of deductibility of losses arising from an employee's defalcation is *Curtis v J & G Oldfield Limited*³, a 1925 UK case. In *Curtis*, after the death of the company's managing director, it was found that many of his personal expenses passed through the company's books and these were written off as bad debts. The Revenue denied a deduction. In the High Court, Rowlatt J thought that defalcations by subordinate employees are normally deductible, but money misused by a controlling

¹ [2011] SGHC 229

² Section 93A(1) provides that "If any person who has paid tax for any year of assessment alleges that an assessment is excessive by reason of some error or mistake in the return or statement made by him for the purposes of the assessment...he may, at any time not later than 6 years (if the year of assessment within which the assessment was made is 2007 or a preceding year of assessment)...after the end of the year of assessment within which the assessment was made, make an application in writing to the Comptroller for relief."

³ (1925) 9 TC 319

individual was an application of profits, not an expense in earning profits. It was held that the bad debt was outside the company's trade and hence not deductible. *Curtis* has since been discussed in many Commonwealth cases. It was applied in some cases, distinguished in others. The South African approach was said to be the most straightforward: money lost through any form of embezzlement is not deductible because the loss was not incurred in the production of the company's income.⁴

What the High Court said

Deductibility of loss

On the tax deductibility question, Tay Yong Kwang J emphasised that there must exist a nexus between the expense and the income produced for a deduction to be allowed.⁵ *Curtis* was discussed at length and the Comptroller contended that the case stood for the principle that there should be no deduction for a loss incurred by a director "in a position to do exactly what he likes".

Tay J concluded that the Board of Review had correctly applied the test in *Curtis* as he understood it: did the defalcator possess an overriding power or control in the company and was the misuse committed in exercising such power or control? This is a question of fact and one has to look at the factual arrangements within the company for an answer.

Interestingly, Tay J took the view that the *Curtis* test should be understood as a common law exception developed so as to give sufficient nexus between certain defalcation losses and the production of income such that a deduction could be allowed. Strictly, one could read section 14(1) of the Act as leaving no room for a deduction claim in a defalcation case; there is simply no connection between an employee misusing a company's funds and the production of income.⁶ He was of the view that the exception is justified on policy grounds: the unlikelihood of large firms being able to keep tabs on all employees and the need to deter companies from leaving the powers of their directors and shareholders unchecked. Applying the above in the present case, it was said that C did possess overriding power or control in the company and the misuse of funds was committed in the exercise of such power or control. The loss was therefore not tax deductible.

Error or mistake

Though Tay J did not think it strictly necessary to deal with the second issue given the decision on the first, he nevertheless explained why he preferred the Board of Review's view of what constitutes an error or mistake under section 93A(1) to that of the Comptroller. Essentially, he agreed with the Board of Review's view that an error or mistake under Section 93A covers genuine mistakes of law, and they are not restricted to mere "ignorance or inadvertence", as submitted by the Comptroller. That said, a qualification exists within section 93A(3). This sub-section provides that a taxpayer is not entitled to the relief if "the return...was in fact made...in accordance with the practice of the Comptroller generally prevailing at the time when the return...was made." He thought that the Comptroller could have easily countered the taxpayer's claim by proving that it was the Comptroller's generally prevailing practice at the relevant point in time to treat losses caused by defalcating directors as non-deductible.

⁴ *Lockie Bros Ltd v Commissioner for Inland Revenue* (1922) 32 SATC 150

⁵ Section 14(1) provides that "For the purpose of ascertaining the income of any person for any period from any source chargeable with tax under this Act...there shall be deducted all outgoings and expenses wholly and exclusively incurred during that period by that person in the production of the income...."

⁶ Paragraph 71 of the judgment

How it affects you

On the deduction side, this case makes it clear that losses arising from money misused by a controlling individual in a company are not deductible.

As to Tay J's view on what constitutes "error or mistake", technically the comments are made in passing and create no binding precedent. They are, however, of persuasive value in future cases. That said, one must bear in mind the caveat of "practice generally prevailing" at the material time, as expounded by Tay J. That is, if the Comptroller was "also operating under the same mistake",⁷ the error or mistake claim made by the taxpayer is unlikely to succeed. (Again, while not binding, this remark is of persuasive authority.)

It is interesting to ask what the position would be if the "practice generally prevailing" came about as a result of the IRAS reading or applying the law which is then found to be erroneous in court. Questions also remain as to what happens if the IRAS subsequently changes its practice. This may not be a happy situation for the taxpayer who is bound by a prevailing practice found erroneous in law.

⁷ Paragraph 104 of the judgment

Get in touch

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