Corporatisation to provide personal services an act of tax avoidance?

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The recent decision of *GCL v Comptroller of Income Tax* [2020] SGITBR 1 (GCL) deals with an arrangement carried out by a dentist who had incorporated a company to supply dental services previously provided by himself as an employee. The Comptroller of Income Tax (the Comptroller) invoked the general anti-avoidance rule (GAAR) in section 33 of the Income Tax Act (ITA) and assessed the service income received by the company to tax in the hands of the dentist. The Income Tax Board of Review (the Board) found the setting up of the company by the dentist to provide dental services not in itself an act to avoid tax. However, the significantly low level of remuneration paid by the company to him amounted to tax avoidance.

Background

The salient facts in GCL are:

- From January 2011 to May 2012, the taxpayer, a licensed dentist, was employed by an orthodontic clinic (YCO) and derived employment income.
- The employment income was brought to tax in the hands of the taxpayer.
- On 1 May 2012, the taxpayer incorporated a private limited company, GCL, with him being the sole director and shareholder. He then ceased employment with YCO.
- The taxpayer continued to provide dental services to YCO at the latter’s premises but under the new arrangement, YCO paid service fees to GCL which would then pay director’s fees, dividends and salaries to the taxpayer.
- The Comptroller was of the view that the incorporation and provision of services through GCL was a scheme to avoid tax. Therefore, the Comptroller assessed the service income received by GCL as income of the taxpayer on an individual tax basis.
- The taxpayer disagreed and the issue was brought to the Board.

Issues considered by the Board

The key issues before the Board are:

(a) Whether the following arrangement as noted by the Comptroller falls within the ambit of section 33 of the ITA.

(i) Incorporating a company to receive income for the provision of dental services (previously received directly by the taxpayer); and

(ii) Setting a level of remuneration paid by GCL to the taxpayer that was artificially low, such that the profits of GCL may be paid to the taxpayer as tax exempt dividends.

(b) Whether, as an alternative to section 33, the New Zealand’s decision of *Spratt v Commissioner of Inland Revenue* [1964] NZLR 272 (Spratt) cited by the Comptroller could apply, such that income from personal exertion by natural persons (“personal exertion principle”) cannot be assigned or diverted to another person.
The Board's findings and decision

(a) Whether the arrangement falls within the ambit of section 33 of the ITA

The Board was of the view that the arrangement purported by the Comptroller was in fact two arrangements, one being the incorporation of a company to provide dental services and the other the level of the taxpayer's remuneration. Adopting the analytical framework set out by the Court of Appeal in Comptroller of Income Tax v AQQ and another appeal [2014] SGCA 15 (AQQ), it considered how section 33 applied to each of these arrangements.

To recap, a three-step analysis was taken to interpret section 33 under AQQ:

Step 1: Consider whether an arrangement prima facie falls within any of the following three threshold limbs of section 33(1), such that the taxpayer has derived a tax advantage:

(i) Altering the incidence of any tax which is payable by or which would otherwise have been payable by any person;
(ii) Relieving any person from any liability to pay tax or to make a return; or
(iii) Reducing or avoiding any liability imposed or which would otherwise have been imposed on any person.

Step 2: Consider whether the taxpayer may avail himself of the statutory exception under section 33(3)(b), i.e. that the arrangement was carried out for bona fide commercial reasons, and that tax reduction or avoidance is not one of its main purposes ("the bona fide exception");

Step 3: If not, consider whether the taxpayer has satisfied the court that the tax advantage obtained arose from the use of a specific provision in the ITA that was within the intended scope and Parliament’s contemplation and purpose, both as a matter of legal form and economic reality within the context of the entire arrangement.

(i) Incorporation of a company to provide dental services

Firstly, the Board examined whether a tax advantage was derived within the ambit of section 33(1) based on the facts of the arrangement, without considering the subjective motive(s) of the taxpayer. In doing so, it applied the "predication principle". This means 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 the arrangement is not an act of tax avoidance.

The Board found the incorporation of a company to carry out a dental practice to be common, and not inherently a tax avoidance arrangement. Therefore, the act of incorporation was not caught by section 33(1), and there was no need to consider the subjective motive of the taxpayer to determine if the bona fide exception can apply. Nonetheless, it agreed that the taxpayer's reasons for incorporation (such as to facilitate future expansion and to limit business risk and liabilities) are natural benefits of operating business through an incorporated entity. Even though the income derived by a company was taxed at a rate which is lower than the highest marginal individual tax rate, it is the natural consequence of tax policy and not an act of tax avoidance.

It is also worth noting that the Board observed, in obiter, that whether the taxpayer had carried out those plans (e.g. business expansion) in the years in question, such that he would have needed to avail himself of the purported commercial benefits of incorporation, was irrelevant. It was sufficient that at the time of incorporation, the taxpayer chose a form of business operation that would give him the intended commercial advantages.

(ii) Level of taxpayer's remuneration

The Board next applied the first step of the approach adopted in AQQ to the level of remuneration paid to the taxpayer, and found that the artificially low remuneration paid to the taxpayer after incorporation (as compared to what he received as an employee of YCO) fell within section 33(1)(a) or (c) and constituted tax avoidance. The effect of the arrangement was that the profits remaining in GCL were taxed at the lower corporate rate (compared to the individual’s), with the after-tax profits paid as tax exempt dividends to the taxpayer.

Next, the Board considered whether the taxpayer may avail himself of the bona fide exception. This in turn depended on the taxpayer's subjective motive for entering into the arrangement.

Given that the taxpayer’s personal role before and after incorporation remained largely the same, the Board viewed the significantly lower remuneration after incorporation, which was based on the taxpayer's personal upkeep and maintenance requirement, as neither commercial nor reflective of reasonable remuneration. It found that the basis of remuneration was not commercial and that one of the main purposes of the arrangement was the avoidance of tax. As such, the bona fide exception cannot apply.

Lastly, the Board considered whether the tax advantage obtained by the taxpayer arose from the use of a specific provision in the ITA that was within the intended scope and Parliament’s contemplation and purpose. The relevant provisions in this case were start-up tax exemption (SUTE) and partial tax exemption (PTE) under sections 43(6A).
and 43(6)\(^3\) of the ITA respectively, as most of GCL’s taxable income was subject to these tax exemptions in the Years of Assessment (YAs) in question (i.e. YA 2013 to 2016). The Board noted that for those years, the taxpayer’s remuneration was set at a level that happened to result in the maximisation of the SUTE/PTE benefit. The Board agreed with the Comptroller that Parliament's intent for the SUTE and PTE is to encourage entrepreneurship through incorporation, and that the taxpayer’s use of these provisions in order to avoid tax does not fall within such intent.

(b) Whether personal exertion principle applies in Singapore

The Comptroller submitted the “personal exertion principle” as an alternative basis to tax GCL’s income in the hands of the taxpayer, given that the income was earned through personal exertion of the taxpayer. His detailed basis for relying on Spratt was not set out in the Board’s decision. It is, however, noted in Spratt that Henry J, in considering whether the assignment for value of a sum of money out of trust income of future years by an individual may result in the alienation of the sum so assigned, observed as follows (at page 277):

No taxpayer can, by way of assignment, escape assessment of tax on income resulting from his personal activities – such income always remains truly his income and is derived by him irrespective of the method he may adopt to dispose of it.

There was also a passing reference to Barry George Hadlee v Commissioner of Inland Revenue [1993] AC 524, a New Zealand case heard by the Privy Council, which involved the assignment of shares in a partnership and whether that was effective to render the assignor not taxable on income attributable to those shares.

On the grounds that the facts of these decisions are quite different from those of the case being heard, and there is no provision in the ITA that requires income of a company to be attributed to individuals (outside of the operation of section 33), the Board held that the personal exertion principle should not be applied in Singapore.

Although not raised by the Comptroller, the Board further noted that the taxpayer, being the sole director and shareholder of GCL, is a related party to GCL. As such, an arm’s length remuneration should be paid by GCL to the taxpayer in accordance to section 34D of the ITA. It found the setting of the artificially low remuneration not only an act of tax avoidance, but also in breach of the arm’s length principle under section 34D.

In summary, the Board found that the artificially low level of remuneration paid by GCL to the taxpayer fell within the ambit of section 33 and gave rise to tax avoidance.

PwC’s comments

While the use of a specific business structure is the choice of taxpayers, it should be driven by commercial considerations and carried out in a manner that is consistent with economic realities of the arrangement.

Businesses seeking to incorporate to better fit their operating needs, and those which have already done so, will be heartened to know that such an option is open to them and does not necessarily run afoul of anti-avoidance rules.

It is useful to note, however, that certain considerations followed the Board’s decision:

In GCL, the Board has chosen to treat the incorporation and level of remuneration as two separate arrangements, and it found (only) the latter to be tax avoidance. In AQK, the Court of Appeal recognised the Comptroller’s discretion to particularise the impugned arrangement. The arrangement so particularised, and thus the tax advantage sought, will naturally determine how the Comptroller will go about counteracting the advantage. In choosing to view the arrangement here as a composite whole rather than the two component steps, it appears the Comptroller had been constrained in invoking the arm’s length principle in challenging the artificially low level of remuneration. Otherwise one might ask why he did not choose this course of action, since its circular “Incorporation of companies by medical professionals and relevant tax implications” issued in November 2019 has highlighted the need for such medical professionals to be paid at arm’s length by their companies.

Next, even though the Board mentioned that whether the taxpayer had carried out the plans necessitating incorporation was irrelevant, the importance of follow-through implementation of the original plan should not always be dismissed. In an earlier Board of Review case, GBF v Comptroller of Income Tax [2016] SGITBR 1 (GBF), the failure to execute the original plan, coupled with the lack of contemporaneous documentation to evidence the commercial purpose of the restructuring, led the Board to conclude that one of the main purposes of the arrangement was to avoid tax. On a practical level, execution of the plan would serve to corroborate the original intent, which will be helpful in supporting the commercial purpose behind the business structure chosen.

In conclusion, while the Board is cognisant of the commercial reasons behind incorporation, whether or not there is tax avoidance is dependent on the facts of each case, involving an enquiry into the subjective motive of the taxpayer for entering into the arrangement and the consequences sought, the economic realities involved, as well as the manner in which the arrangement is carried out in the light of the specific legislative provision being considered.

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\(^3\) Section 43(6A) with effect from 12 November 2018
Given the differential between corporate and personal tax rates, it should not be surprising for the IRAS to review whether there is any abuse of corporatization from a tax perspective. Thus, taxpayers should ensure that (a) each component of the overall arrangement (whether it is the remuneration level or its business plans) is supportable as a matter of economic reality, (b) there is contemporaneous documentation of the commercial reasons for their chosen business structure, and (c) such intent should be carried out (and if not, the reasons for not doing so). This is so that they are in the position to explain the choice taken if called upon to do so.

For a deeper discussion of how the above might affect your business, please feel free to contact:

Chris Woo
Tax Leader
chris.woo@pwc.com
+65 9118 0811

Paul Lau
Tax Partner
paul.st.lau@pwc.com
+65 8869 8718

Abhijit Ghosh
Tax Markets Leader
abhijit.ghosh@pwc.com
+65 8223 0698