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The Tax Treatment of Haircuts in Financial Reorganizations

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THE TAX TREATMENT OF HAIRCUTS IN FINANCIAL REORGANIZATIONS

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Over the past few years, Singapore has implemented various ambitious insolvency reforms aimed at making the country an international hub for debt restructuring. This article argues that while Singapore has put in place one of the most sophisticated restructuring frameworks in the world, some tax reforms might be useful to maximise the potential of this new restructuring framework. Namely, it will be pointed out that the tax treatment of debt forgiveness granted by creditors in corporate reorganisation ('haircuts') should be reviewed. Under the current legislation, these haircuts may be treated as taxable income. As a result, financially distressed debtors may be required to pay taxes for certain income that did not involve any actual generation of cash flows. This article argues that, by implementing tax reforms, local and foreign companies will be able to maximise the benefits associated with having access to the efficient insolvency framework implemented in Singapore.

I INTRODUCTION

Over the past few years, Singapore has taken several steps with the purpose of becoming an international hub for debt restructuring. First, the Government has implemented a very ambitious insolvency reform, leading to the new Insolvency, Restructuring and Dissolution Act 2018 ('IRDA'), [1] that provides various tools to preserve value and promote the successful debt restructuring of viable companies facing financial troubles. These tools include an enhanced moratorium or automatic stay against enforcement actions by creditors, the availability of rescue financing, the restriction of clauses terminating contracts as a result of the commencement of a reorganisation procedure (*ipso facto* clauses), and the possibility of imposing a reorganisation plan on dissenting classes of creditors (usually referred to as a 'cross-class cramdown'). Second, the insolvency reforms taking place in the past years, consolidated in the IRDA, have expanded the scope of companies allowed to use the new restructuring framework implemented in Singapore. Namely, foreign companies will be allowed to use this new restructuring framework provided that they prove a substantial connection with Singapore. This substantial connection can be shown through a variety of mechanisms, including proving that the debtor: (i) has its centre of main interest in Singapore; (ii) is carrying on business in Singapore or has a place of business in Singapore; (iii) has substantial assets in Singapore; (iv) has chosen Singapore law as the law governing a loan

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1 Insolvency, Restructuring and Dissolution Act 2018 (Singapore, No. 40 of 2018). This Act was enacted in 2018 and is expected to come into force in 2020.

or other transactions; or iv) has submitted to the jurisdiction of the Singapore courts in the resolution of one or more disputes relating to a loan or other transactions.[2]

Our article suggests that, while Singapore has managed to put in place one of the most sophisticated restructuring frameworks probably existing in the world,[3] tax reforms can be implemented to maximise the potential of this new restructuring framework, not only for the benefit of local companies but also for foreign debtors and creditors interested in having access to the efficient restructuring framework implemented in Singapore.

One of the goals of engaging in a corporate reorganisation is allowing companies to emerge from insolvency with a new financial structure that is more suitable with the company's current and future cash flows.[4] In order to achieve this goal, debtors and creditors usually reach an agreement that generally includes deferrals on payments as well as debt forgiveness, commonly known as 'haircuts' in the insolvency jargon.[5] This agreement then has to be accepted by a majority or qualify majority of creditors.[6] Once accepted, the agreement, including the haircuts and deferrals in payments, will be binding on the company's creditors, including those who voted against the reorganisation plan.[7]

2 See IRDA s 63(3) read with ss 246(1)(d) and 246(3).

3 In fact, the Singapore reform seems to be inspiring the insolvency reforms taking place in other restructuring hubs around the world. Among others, the United Kingdom ('UK') is currently discussing the adoption of a new reform that seeks to implement a variety of the restructuring tools currently available in Singapore. See Corporate Insolvency and Governance HC Bill (2019–21). The Netherlands has also implemented a similar insolvency reform. See Jasper Berkenbosch, Erik Schuurs and Sid Pepels, 'The Dutch Scheme: A Valuable Addition To Cross-Border Restructuring Toolbox' (7 February 2020), <https://www.mondaq.com/insolvencybankruptcy/891326/the-dutch-scheme-a-valuable-addition-to-cross-border-restructuring-toolbox> accessed 26 May 2020.

4 Barry E Adler, Douglas G Baird, and Thomas H Jackson, *Bankruptcy: Cases, Problems and Materials* (Foundation Press, 4th ed, 2007) 26-9.

5 Matt Clinch, 'Why the IMF is wrong on a Greek debt haircut' CNBC (online, 19 August 2015) < https://www.cnbc.com/2015/08/19/why-the-imf-is-wrong-on-a-greek-debt-haircut.html>.

6 In Singapore, a reorganisation plan has to be approved a majority of the creditors representing 75% in value of the debt of creditors present and voting at the meeting. See Companies Act (Singapore, Cap 50, 2006 Rev Ed) s 210(3).

7 Outside of insolvency law, an adjustment of debts such as the modification of the debtor's financial obligations would require consent from *all* the creditors involved. Since this unanimity rule can be very costly to obtain (especially in the context of large insolvency proceedings with many dispersed creditors), and it may actually lead to various forms of opportunistic behaviour by individual creditors, insolvency law imposes different rules for the approval of a restructuring plan. Under insolvency law, debtors can impose a plan on dissenting creditors in a practice generally known as 'cramdown'. There are two types of cramdown. First, an inter–class or cross–class cramdown, just known as 'cramdown' in the United States ('US'), which takes place when a reorganisation plan is imposed on one or more dissenting *classes* of creditors. Second, an inter–class cramdown which takes place when a plan is imposed on individual dissenting creditors within the same class. Therefore, this intra–class cramdown is not really a cramdown but really the imposition of a *majority rule* in the approval of a reorganisation plan. See Aurelio Gurrea–Martinez, 'The Future of Reorganization Procedures in the Era of Pre–Insolvency Law' (2020) *European Business Organization Law Review* (Forthcoming) (Ibero–American Institute for Law and Finance Working Paper No 6/2018, Singapore Management University School of Law Research Paper No 34/2019) <https://ssrn.com/abstract=3290366>.

From an accounting perspective, a haircut may be seen as exceptional income by the debtor.[8] Therefore, unless this income is exempted, the debtor may be subject to a tax bill of approximately 17% of the value of the haircut at the end of the debtor's next financial year. Therefore, since this income did not generate any cash flows for the debtor, the payment of these taxes associated with a haircut can harm the successful reorganisation of a viable company that may still be facing liquidity problems.

Our article starts by analysing two primary issues arising in corporate reorganisations from a tax perspective: (i) the uncertainty of whether forgiven loans will indeed be taxed as income; and (ii) the taxation of forgiven loans found to be income. In the case of the first issue, there are a multitude of factors which may be relevant in determining whether a haircut is in fact the income of the distressed company. Three main questions are often relevant in this determination. Namely, it is controversial whether the haircut: (i) is in the nature of income or capital; (ii) can be said to be income from a new trade or business of the company in liquidation/judicial management; and (iii) can be said to be 'foreign-sourced'. These three questions are by no means easy to answer for the legal position is not always particularly clear on these points. The uncertainty with respect to the tax treatment of the forgiven loans is likely to be a matter of considerable concern to all parties involved in the restructuring process and we suggest that an appropriate way to deal with such uncertainty may be through the enactment of safe-harbour provisions that can determine the issue and eliminate uncertainty. Such safe-harbour provisions may be in the nature of provisions exempting any income that may result from the forgiven loans in the context of formal reorganisation procedures, or in the nature of deeming provisions that deem any forgiven loans to be in the nature of capital and thus not taxable under Singapore tax law.

The second issue relates to the taxation of forgiven loans found to be income and whether they should in fact be taxed. As the main problem with a distressed company is likely to be an immediate cash flow issue, there are two main approaches which can be taken with respect to the taxation of such income: (i) exemption; or (ii) deferment. In the case of the former, any tax payable on the loan is simply exempted and need not be paid, while in the case of the latter, the tax payable may be deferred to a later time when the company is in a better financial situation to make the payment. While both approaches are technically possible, we suggest, based on a review of other jurisdictions, that an exemption of such income may be a better approach.

It is our hope that, in dealing with the uncertainty of the tax treatment of forgiven loans and in exempting them from taxation, Singapore will be able to maximise the potential of the new restructuring framework. Our article then deals with preventing the opportunistic use of these tax exemptions. For example, companies may have incentives to opportunistically extend loans to another, which it then writes off, thereby gaining a deduction without any corresponding tax treatment on the part of the debtor company. The second company may then do the same, resulting in a series of transactions with no purpose other than to gain tax benefits. We propose to deal with this blatant tax avoidance scheme (and other schemes) by: (i) limiting the measures proposed above to situations involving a distressed company undergoing insolvency proceedings; (ii) excluding related companies from such measures in certain circumstances; and (iii) expressly creating a General Anti-Avoidance Rule that would empower the Inland Revenue Authority of Singapore (the 'IRAS') to reverse the effect of any transaction entered into to abuse the framework.

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[8] As will be discussed below, whether a haircut is treated as income for tax purposes is dependent on the nature of the loan. See *CIT v IA* [2006] 4 SLR(R) 161, [62]; *T Ltd v CIT* [2006] 2 SLR(R) 618, [24]; *BFC v CIT* [2014] 4 SLR 33, [28]-[33].

Finally, our article mentions that with the purpose of maximising the potential of the new restructuring framework implemented in Singapore, not only for the benefit of local companies but also for the benefit of foreign debtors and creditors interested in making use of the new restructuring framework implemented in Singapore, other countries should adopt similar tax reforms.

II Steps Taken to Make Singapore an International Hub for Debt Restructuring

In the past few years, Singapore has implemented various reforms with the purpose of becoming an international hub for debt restructuring.[9] While these reforms primarily affect schemes of arrangement, some of them are also applicable to the judicial management.[10]

First, the new restructuring framework allows debtors to enjoy an enhanced moratorium to protect them from any legal actions taken by the creditors. Even though a moratorium was already available before the reform, this moratorium has become more powerful in several ways. First, it now protects the debtors against secured creditors – a possibility not existing under the old regime.[11] Second, the new moratorium has worldwide effects and it may affect related companies.[12] Finally, the debtor will enjoy an automatic moratorium which has the possibility of being extended.[13]

Second, inspired by the US Chapter 11 reorganisation procedure, the new restructuring framework implemented in Singapore allows debtors to impose a reorganisation plan on dissenting classes of creditors, in a practice generally known as 'cramdown' or 'cross–class cramdown'.[14] While dissenting creditors will still be subject to several safeguards,[15] the possibility of imposing the plan

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9 These steps included most of the recommendations expressed by the group of experts appointed by the Singapore Government when amending the insolvency regime. See Report of the Insolvency Law Review Committee (Final Report, 2013) <https://www.mlaw.gov.sg/files/news/announcements/2013/10/ReportoftheInsolvencyLawReviewCommittee.pdf>. For a summary of the new restructuring framework in Singapore, see Indranee Rajah, 'Enhancing Singapore an International Centre for Debt Restructuring for Asia and Beyond' (2017) <https://app.mlaw.gov.sg/files/NoteonDebtRestructuring.pdf/>. For an analysis of the new restructuring framework in Singapore, see Meng Seng Wee, 'Whither the Scheme of Arrangement in Singapore: More Chapter 11, Less Scheme?' (February 2017) <https://ssrn.com/abstract=2922956>; Gerard McCormack and Wai Yee Wan, 'Transplanting Chapter 11 of the US Bankruptcy Code into Singapore's restructuring and insolvency laws: opportunities and challenges' (2018) 19(1) *Journal of Corporate Law* 69.

10 The IRDA will now allow for an out of court commencement of judicial management and permit judicial managers to assign proceeds arising from certain insolvency related claims. See IRDA s 94 and First Schedule para (f).

11 IRDA s 64(1).

12 IRDA s 64(5).

13 IRDA s 64(8).

14 Aurelio Gurrea–Martinez, 'The Future of Reorganization Procedures in the Era of Pre–Insolvency Law' (2020) *European Business Organization Law Review* (Forthcoming) (Ibero–American Institute for Law and Finance Working Paper No 6/2018, Singapore Management University School of Law Research Paper No 34/2019) <https://ssrn.com/abstract=3290366>.

15 Safeguards includes the best interest of creditors test, a requirement that any reorganisation plan has to be fair and equitable and that a majority of creditors in number representing 75% in value of the creditors present and voting agreed to the reorganisation plan. See IRDA s 70.

on dissenting classes of creditors is expected to facilitate debt restructurings by reducing negotiation costs and the potential existence of holdout problems by certain minority creditors.[16]

Third, debtors in financial distress usually have trouble accessing new financing. The new restructuring framework addresses this problem by implementing a system of rescue financing. According to this system, creditors providing new financing to debtors subject to a restructuring procedure may enjoy a super priority status provided that certain requirements are met and the court authorises this new financing.[17]

Fourth, many suppliers having businesses with financially distressed debtors may have incentives to terminate their contracts with their debtors, and they may have actually included some contractual clauses to do so in the event of insolvency.[18] Under the new restructuring framework implemented in Singapore, parties will be unable to terminate their contracts just because the debtor has initiated a restructuring procedure.[19]

Fifth, unlike what happens in formal insolvency proceedings such as winding up and judicial management, debtors using the Singapore scheme of arrangement are not required to appoint an insolvency practitioner. Therefore, they will be allowed to keep running the company during the procedure. As a result, the new restructuring framework provides debtors with most of the features existing in formal insolvency procedures while allowing the debtor to remain in possession. This debtor-in-possession model of governance of insolvency proceedings is expected to create many benefits, including encouraging debtors to initiate restructuring procedures at an early stage.[20]

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16 Aurelio Gurrea–Martinez, 'The Future of Reorganization Procedures in the Era of Pre–Insolvency Law' (2020) *European Business Organization Law Review* (Forthcoming) (Ibero–American Institute for Law and Finance Working Paper No 6/2018, Singapore Management University School of Law Research Paper No 34/2019) <https://ssrn.com/abstract=3290366>. Stating that reducing holdout problems is one of the main goals of insolvency law, see Anthony J Casey, 'Chapter 11's Renegotiation Framework and the Purpose of Corporate Bankruptcy' (16 March 2019) *Columbia Law Review* (Forthcoming) <https://ssrn.com/abstract=3353871>.

17 IRDA s 67. In order for super priority to be granted, the debtor has to show attempts at securing financing on a normal basis before the court will consider its exercise of discretion to grant super priority. See Ajinderpal Singh and Adriel Chioh, 'Rescue Financing in Singapore: Navigating Uncharted Waters' [2020] *Singapore Academy of Law Practitioner* 1.

18 These clauses are generally known as '*ipso facto* clauses'. See Aurelio Gurrea–Martinez, 'The Future of Reorganization Procedures in the Era of Pre–Insolvency Law' (2020) *European Business Organization Law Review* (Forthcoming) (Ibero–American Institute for Law and Finance Working Paper No 6/2018, Singapore Management University School of Law Research Paper No 34/2019) <https://ssrn.com/abstract=3290366>.

19 IRDA s 440. While prohibiting a counterparty from terminating a contract on the basis that the debtor is insolvent, other substantive grounds such as non-payment or non-performance by the debtor will continue to be valid.

20 Gerard McCormack and Wai Yee Wan, 'Transplanting Chapter 11 of the US Bankruptcy Code into Singapore's restructuring and insolvency laws: opportunities and challenges' (2018) 19(1) *Journal of Corporate Law* 69. In the US, see Douglas G Baird, 'The initiation problem in bankruptcy' (1991) 11(2) *International Review of Law and Economics* 223. Testing empirically that making creditors more powerful in bankruptcy discourages debtors from commencing insolvency proceedings in a timely manner, see Barry E Adler, Vedran Capkun and Lawrence A Weiss, 'Theory and Evidence on the Bankruptcy Initiation Problem' (2006) <https://law.bepress.com/cgi/viewcontent.cgi?article=1655&context=alea>.

Finally, in addition to the restructuring tools mentioned above,[21] the reforms recently implemented in Singapore allow foreign companies to make use of this restructuring framework provided that they prove a substantial connection with Singapore, usually by showing that their centre of main interest is located in Singapore, their contracts are subject to Singapore law, they have voluntary submitted themselves to the jurisdiction of the Singapore court, or their business is primarily conducted in Singapore.[22] By expanding the jurisdiction of Singapore courts, more foreign companies will be able to use this new restructuring framework, achieving Singapore's goals of becoming an international hub for debt restructuring.[23]

This article argues that, while Singapore has managed to put in place one of the most sophisticated restructuring frameworks existing in the world,[24] a tax reform can be implemented to maximise the potential of this new restructuring framework. Namely, we believe that income associated with a debt forgiveness potentially agreed (or even imposed) upon in a financial reorganisation should exempted. Otherwise, debtors might be required to pay for an income that did not generate any cash flows, harming the financial situation of a debtor that might still be facing liquidity problems.

III The Tax Treatment of Haircuts in Singapore

A *The General Position*

Under Singapore Tax Law, income falling under any of the heads of charge listed in section 10(1) of the Income Tax Act (the 'ITA')[25] is exigible to tax. Capital gains are not taxable in Singapore. The question in the present case is whether a haircut may be considered to be income for the purposes of the ITA. Under Financial Reporting Standards ('FRS') 39 and 109,[26] there are two

21 The insolvency reforms implemented in 2017/2018 includes other measures. However, this article just mentions those measures that can be considered 'restructuring tools', and therefore have the potential to contribute to Singapore becoming an international hub for debt restructuring. For an analysis of all the reforms implemented in the 2017 – 2018 reforms and which will be consolidated in the IRDA, see Meng Seng Wee, 'Whither the Scheme of Arrangement in Singapore: More Chapter 11, Less Scheme?' (February 2017) <https://ssrn.com/abstract=2922956>; Gerard McCormack and Wai Yee Wan, 'Transplanting Chapter 11 of the US Bankruptcy Code into Singapore's restructuring and insolvency laws: opportunities and challenges' (2018) 19(1) *Journal of Corporate Law* 69. Mohan Gopalan, 'The Moratorium under Sections 210(1) and 211B of the Companies Act' [2019] *Singapore Academy of Law Practitioner* 2; Ajinderpal Singh and Adriel Chioh, 'Rescue Financing in Singapore: Navigating Uncharted Waters' [2020] *Singapore Academy of Law Practitioner* 1.

22 See IRDA s 63(3) read with ss 246(1)(d) and 246(3).

23 Analysing whether Singapore will achieve this goal, see Noel McCoy, 'Will Singapore become an international centre of debt restructuring? A comparative analysis of Singapore's bold insolvency reforms' (INSOL Special Report, November 2018) <https://www.nortonrosefulbright.com/-/media/files/nrf/nrfweb/imported/will-singapore-become-an-international-centre-of-debt-restructuring.pdf?la=en&revision=f9c52781-4a5d-46d8-93b2-4096de5308c7>.

24 In addition to the attractiveness of the insolvency laws themselves, it should be kept in mind that Singapore also has a sophisticated judiciary, making the entire insolvency framework even more attractive. See Sean Lim, 'Singapore ranks 13th in the world for rule of law, and has the highest score for order and security' Business Insider (online, 1 March 2019) <https://www.businessinsider.sg/singapore-ranks-13th-in-the-world-for-rule-of-law-and-has-the-highest-score-for-order-and-security>.

25 Income Tax Act (Singapore, cap 134, 2014 rev ed) (the 'ITA').

26 FRS 109 has been applied by most companies in Singapore for annual periods beginning on or after 1 January 2018, replacing the old FRS 39. For the purposes of this article, the tax effect of adopting either standard is substantially similar.

measurement categories for loans which are financial liabilities: (i) financial liabilities designated as Fair Value Through Profit or Loss ('FVTPL'); and (ii) financial liabilities designated at amortised costs. Generally, the former category is made up of financial liabilities which are held for trading, while the latter category is made up of all other financial liabilities unless the fair value option is elected.[27]

Under section 34A(1) of the ITA,[28] 'the amount of any profit or loss… brought into account… in accordance with FRS 39… is recognised in determining any profit or loss (as the case may be) or expense in respect of that financial instrument for that year of assessment.'[29] Thus, any gain or loss which is recognised in the Profit and Loss account of the relevant company in accordance with FRS 39 will, *prima facie*, accordingly be taxed or allowed as a deduction. While there does not seem to be any Singapore case law considering this point in particular, a plain reading of the statute supports this position. In addition, several Indian cases make it clear that haircuts are to be considered as income accruing to the debtor.[30] However, gains or losses in the nature of capital are precluded from being taxed or allowed as a deduction,[31] leaving only gains or losses in the nature of revenue that may be accordingly taxed or allowed as a deduction.[32]

In the present case, a haircut will be reflected as a gain in the Profit and Loss account of the relevant company in accordance with FRS 39. If the haircut is in the nature of capital, it will not be taxable, while if it is of an income nature, it will be taxable as the income of the relevant company.[33] As noted above, this can be a cause for major concern for the distressed company, for it would then have to pay income tax on the 'gain' received from the forgiven loan. This may amount to up to 17% of the quantum of loan forgiven, which is the headline corporate tax rate in Singapore. One may reasonably expect that a distressed company undergoing insolvency proceedings would be unable to raise the money to pay the tax due, making its already precarious situation considerably worse.

B *Uncertainty as to the Taxability of Forgiven Loans*

While this is the general position of whether forgiven loans are taxable, the difficulty lies in classifying the nature of the forgiven loan, for there are a variety of factors which can affect whether it is in fact taxable. The legal position with respect to these factors is by no means clear, as will be illustrated by our discussion of the following.

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27 Barry Epstein, *Financial Instruments*, (Institute of Singapore Chartered Accountants, 2014) 21.

28 Where FRS 109 is used instead, the corresponding provision is s 34AA.

29 Exceptions to this general rule are laid out in s 34A(2), the most relevant exception of which is s 34A(2)(c): 'any amount of profit or expense in respect of a loan for which no interest is payable shall be disregarded'.

30 See *Orient Corporation, Bombay v CIT* [1950] 18 ITR 28; *Solid Containers v DCIT* (2009) 308 ITR 417; *Logitronics Pvt Ltd v CIT* 178 (2011) DLT 275.

31 Section 10(1) of the ITA catches only gains or profits of an income nature but not capital nature; and section 15(1)(c) which prohibits deductions on 'any capital withdrawn or any sum employed or intended to be employed as capital except as provided in section 14(1)(h)'.

32 See IRAS, *IRAS e-Tax Guide: Income Tax Treatment Arising from Adoption of FRS 109 – Financial Instruments* (22 November 2017), [6.11].

33 Generally, under section 10(1)(a) of the ITA, as trade or business income, or more exceptionally, under section 10(1)(g) as 'any gains or profits of an income nature not falling within any of the preceding paragraph'.

C *Is the Haircut in the Nature of Income or Capital?*

As noted above, it is only where the haircut is in the nature of income that it may be taxable. Under Singapore tax law, the nature of a loan is determined by the purpose of the taxpayer in taking the loan.[34] This in turn is determined by the main transaction or project which the loan is intended to be used for and whether such transaction or project is itself of a capital or revenue nature.[35] The test to be applied is to 'ascertain whether or not there is a sufficient relationship or linkage between the loan in question and the main transaction or project for which the loan has (ostensibly, at least) been taken.'[36] If the taxpayer is unable to establish such a sufficient relationship, the loan will be capital in nature, since 'it must be assumed that the sole purpose of the loan is to augment or add to the capital structure of the taxpayer.'[37] It is noted that all three cases considered above relate to the deductibility of borrowing costs incurred on loans and not the taxability of 'gains or profits' made on loans. The paucity of the latter sort of case is obvious in that it is uncommon for an arrangement where a debtor ends up owing less to the creditor than the amount he initially borrowed.

While the law on the classification of loans as capital or revenue in nature appears, *prima facie*, to be rather straightforward in this context, the difficulty arises in the practical context, where one has to establish the sufficient relationship or linkage between the loans and the main transactions or project for which they were intended to be used. This can be a particularly tricky task to do in practice, where multiple loans taken out for various different purposes, not always with proper or even any documentation, are the commercial norm. While the taxpayer enjoys a distinct advantage in that any loans which the IRAS cannot link to a revenue purpose will be taken to be capital in nature,[38] and thus, not be taxable, there remains considerable uncertainty regarding the nature of loans for which the IRAS will be able to establish a sufficient relationship or linkage to a revenue purpose. Given the precarious position that distressed companies are already in, this uncertainty is a distinctly unattractive proposition.

D *Is the Haircut Income from a New Trade or Business of the Company in Liquidation/Judicial Management?*

Even if the loan is found to be in the nature of capital under the abovementioned test, it is yet possible for it to be considered to be the taxable income of the distressed company if it can be established that the haircut is income from a new trade or business of the distressed company. The reasoning is as follows.

During insolvency and restructuring proceedings, the distressed company remains the taxable entity and no new taxable entities are brought into being. Through this process, the distressed company may continue its trade or business and the income generated from these activities will be taxable as income in the ordinary way. However, the liquidator or judicial manager (acting for the distressed company) may, in the course of their work, conduct certain activities that may potentially constitute a trade or business. For example, in the liquidation process, gains may be realised on assets which

34 *CIT v IA* [2006] 4 SLR(R) 161, [62]; *T Ltd v CIT* [2006] 2 SLR(R) 618, [24]; *BFC v CIT* [2014] 4 SLR 33, [28]-[33].
35 *CIT v IA* [2006] 4 SLR(R) 161, [69]; *T Ltd v CIT* [2006] 2 SLR(R) 618, [24]; *BFC v CIT* [2014] 4 SLR 33, [28]-[33].
36 *CIT v IA* [2006] 4 SLR(R) 161, [67]; *BFC v CIT* [2014] 4 SLR 33, [28]-[33].
37 *CIT v IA* [2006] 4 SLR(R) 161, [67].
38 *CIT v IA* (n 15) [67].

are sold by the liquidator. If a trade or business of selling such assets can be found, then such gains or profits from the assets may be assessable to income tax under section 10(1)(a) of the ITA.

Similarly, questions may be raised as to whether the activities of a liquidator or judicial manager (acting through the company) in securing the haircuts from creditors, may be said to constitute a trade or business. While it may be a bit of a stretch to argue that the securing of haircuts from creditors is a trade in itself, it is less clear that it cannot be a business. In *Smith v Anderson*, it was said that 'business' 'is a word of large and indefinite import' and 'anything which occupies the time and attention and labour of a man for the purpose of profit is business. It is a word of extensive use and indefinite signification' and that 'the Legislature could not well have used a larger word.'[39]

There is thus some uncertainty as whether it can be said that the liquidator or judicial manager (acting through the company) is operating a new business of securing haircuts on loans from creditors. The paucity of relevant precedents in this area does not help the position. However, some guidance may be obtained from the Malaysian case of *Liquidator, Paramount Ltd v Comptroller General of Inland Revenue*,[40] which involved a company folding up and disposing some land in the process. The question in that case was whether the liquidator was carrying on a trade or business or merely winding-up the affairs of a company on liquidation. It was held that the sales of land essentially formed part of the company's original scheme of profit-making which the liquidator continued, and thus, the gains from sale of such land were subject to tax. In the context of forgiven loans, it is difficult to see how obtaining the haircuts were part of the company's original scheme of profit-making, making the applicability of this case rather limited.

Further guidance may be drawn from the English case of *Baker v Cook (Inspector of Taxes)*, where the relevant test was held to be that a liquidator who only realises the assets of the company and does nothing more than that cannot be said to be carrying on a trade or business.[41] Extending that principle to the present case, it may be argued that since the practice of attempting to secure haircuts from creditors is a normal instance of the insolvency and restructuring process, a liquidator or judicial manager who does nothing more than that cannot be said to be in such a trade or business.

A final difficulty lies in the potential applicability of section 10(1)(g) of the ITA, which provides for the taxation of 'any gains or profits of an income nature not falling within any of the preceding paragraphs.' The difficulty here of course is that 'income' is somewhat of a moving target and it is almost impossible to pin down a precise definition. Jordan CJ commented in *Scott v COT* that: 'The word "income" is not a term of art, and what forms of receipts are comprehended within it, and what principles are to be applied to ascertain how much of those receipts ought to be treated as income, must be determined in accordance with the ordinary concepts and usages of mankind …'[42] There is at the moment neither a test for general 'income', nor a test for income falling within section 10(1)(g), save for cases involving the disposals of assets, which are a completely different kind of situation.[43]

39 *Smith v Anderson* (1880) 15 Ch D 247, 258-259.

40 *Liquidator, Paramount Ltd v Comptroller General of Inland Revenue* (1970) 2 MLJ 193.

41 *Baker v Cook (Inspector of Taxes)* 21 TC 337.

42 *Scott v COT* (1935) 35 SR (NSW) 215, 219.

43 The leading case for section 10(1)(g) income is *IB v CIT* [2004] SGITBR 10, also reported as *DWTH v The CIT* (2005) MSTC 5,347. However, it is arguable that the test laid out in *IB v CIT* can only be applied to situations involving disposals of assets, given the express reference to the intention of the taxpayer at the point of acquiring the asset in the test.

The Income Tax Board of Review in *IB v CIT* did try to define 'income', providing that 'income' encompasses 'the amount of money or its equivalent received during a period of time in exchange for labour or services, from the sale of goods or property, or as profit from financial investments.'[44] On this definition of 'income' at least, it would appear that the activities of liquidators or judicial managers in attempting to secure haircuts would not fall within general income or section 10(1)(g). However, with no case being exactly on point with respect to the current context, there remains some uncertainty as to the taxability of forgiven loans in such situations.

E *Is the Haircut 'Foreign-Sourced'?*

Even if the forgiven loans are found to be in the nature of income, it is still possible that such income may not be taxable in Singapore if it is found to be 'foreign-sourced'. This is a particularly important question in the context of cross-border insolvencies, where a foreign company undergoes insolvency and restructuring proceedings in Singapore.

In Singapore, income tax is levied on the income of any person 'accruing in or derived from Singapore or received in Singapore from outside Singapore' if it falls under any of the heads of charge in section 10(1) of the ITA. There are two bases of taxation: the 'source' basis of taxation and the 'remittance' basis of taxation. As a haircut does not involve an actual transfer of funds into the accounts of the distressed company, it is unlikely that any money will be received in Singapore. However, the question remains whether the haircut is 'Singapore-sourced'.

The concept of 'source' in Singapore tax law is a complex one. The leading case in Singapore is *TTT v CIT*,[45] where the Income Tax Board of Review adopted the principles laid down in the *Hang Seng Bank Case*,[46] as a persuasive authority, although it held that the corresponding provisions of the Hong Kong Inland Revenue Ordinance and the ITA were not *in pari materia*. In the latter case, the Privy Council laid out the relevant principle as follows:

> '[t]he broad guiding principle, attested by many authorities, is that one looks to see what the taxpayer has done to earn the profit in question. If he has rendered a service or engaged in an activity such as the manufacture of goods, the profit will have arisen or derived from the place where the services was rendered or the profit making activity carried on. But if the profit was earned by the exploitation of property assets as by letting property, lending money or dealing in commodities or securities by buying and reselling at a profit, the profit will have arisen in or derived from the place where the property was let, the money was lent or the contracts of purchase and sale were effected. There may, of course, be cases where the gross profits deriving from an individual transaction will have arisen in or derived from different places.'[47]

In the case where the profits were derived from different places, there would be a need to apportion the income accordingly.[48]

The last point must be read together with section 12(1) of the ITA, which provides that '[w]here a non-resident person carried on a trade or business of which only part of the operations is carried on in Singapore, the gains or profits of the trade or business shall be deemed to be derived from Singapore to the extent to which such gains or profits are not directly attributable to that part of the operations carried on outside Singapore.' In other words, if at least part of the operations or

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44 *IB v CIT* [2004] SGITBR 10, [33], approvingly cited in *HZ and another v CIT* [2004] SGITBR 8, [44].
45 *TTT Pte Ltd v CIT* (1995) 2 MSTC 5189.
46 *Commissioner of Inland Revenue v Hang Seng Bank Ltd* [1991] 1 AC 306.
47 Ibid 322-323.
48 Ibid 322.

business are carried out in Singapore, any part of the income that cannot be directly attributable to foreign operations will be deemed to be derived from Singapore.

To answer the question about whether the income from the haircut is foreign-sourced, one must first enquire as to the nature of the income from the forgiven loan. This would involve determining whether the forgiven loans are income in nature because they were initially taken out for a revenue purpose, or whether they are income in nature because of the activities of the liquidator or judicial manager in securing the haircuts. In the case of the former, it is more likely that the income is foreign-sourced, given that the loans were initially taken out overseas, and the distressed company got into dire financial straits overseas, which prompted the creditor to offer the haircut. However, one cannot rule out the possibility that a portion of the income could be apportioned as Singapore-sourced, particularly if negotiations with the creditors took place in Singapore, leading to the realisation of the haircut.

In the case of the latter, it is more likely that the income is Singapore-sourced, given that the liquidator or judicial manager would be operating out of Singapore and seeking to secure haircuts for the distressed company. In either case, the outcome is very fact-dependent and there would be considerable uncertainty as to whether the income was foreign-sourced, and if so, in what proportion.

F *Suggested Safe-Harbour Provisions*

As seen above, in all three situations, there is a fair amount of uncertainty as to the taxability of the forgiven loans, which can be a serious cause of concern for the parties involved in the insolvency and restructuring process. There are two main approaches to the enactment of safe-harbour provisions in this context. Both approaches resolve the uncertainty that comes with the legal positions being uncertain in the three situations. The first would be to provide for an exemption for all income from forgiven loans. In other words, it would not matter whether the forgiven loans were in the nature of income, whether they were the income arising from the activities of the liquidators or judicial managers, or whether they were Singapore-sourced; the classification would be rendered moot since the forgiven loans would not be taxable in any case.

It is noted that, in the absence of any specific provision to the contrary, a tax exemption of any income from forgiven loans would entitle the taxpayer to continue claiming deductions on any expenses which might be incurred on earning that income. In this case, the taxpayer may still wish to classify the forgiven loans along the three situations described above, for if they would be taxable but for the exemption, any expenses relating to them would still be tax deductible. It is noted that this is perhaps an undesirable position, to offer deductions on exempt income. Thus, express provision may be made to make it clear that if the income is exempt, deductions on such income similarly may not be claimed by the taxpayer.

The second approach would be to deem any forgiven loans to be in the nature of capital, and in any case, foreign-sourced. This would have a similar effect of resolving the uncertainty with respect to the three situations described above, since the classification would similarly be rendered moot as the forgiven loans would not be taxable in any case. The key difference here is that by deeming the forgiven loans as such, the taxpayer would not be able to claim any tax deductions on the expenses incurred on the forgiven loans, even in the absence of any other statute expressly providing for this. It is noted that the deeming provision should only have prospective effect from the time of the haircut and not affect the nature of the loan before the haircut. Otherwise, this will affect the deductibility of the interest expenses legitimately incurred in the course of business before the haircut.

We submit that the first approach would be a more straightforward one, since it simply exempts income from forgiven loans, while also preventing deductions on expenses relating to those loans. When compared to deeming provisions, the exemption approach is more conceptually coherent, does not rely on legal fictions, and is less likely to have unintended consequences.

IV THE NATURE AND JUSTIFICATION FOR BENEFICIAL TAX TREATMENT FOR HAIRCUTS

A *Justifying Beneficial Tax Treatment for Haircuts*

The main problem caused by the taxation of forgiven loans is that it adds to the financial burden of an already struggling distressed company and worsens its existing cash flow problems. Further, it discourages creditors from giving haircuts that may be vital to the survival of the distressed company. The effect is particularly pernicious because the impact of the taxation of forgiven loans means that creditors are actually disadvantaged when they give haircuts. The additional tax reduces the pool of assets available to creditors.

However, a legitimate question might be whether any tax will actually have to be paid in practice, even if forgiven loans are recognised as income. It is trite that just because one receives income, it does not mean that income tax is immediately payable. Rather, one must be allowed to set off the relevant expenses, losses and other deductibles before being assessed to tax on one's assessable income. If a distressed company is undergoing insolvency and restructuring proceedings, it may well be racking up considerable expenses and losses to begin with, rendering the question of whether the forgiven loans are income moot, since the deductibles would be sufficient to set off all the income, resulting in no tax actually being payable. It is noted that as forgiven loans will not be taxable if they are of a capital nature anyway, it is only forgiven loans of a revenue nature that must be taken into account here anyway. Such loans may well generally be of a lower quantum than loans taken for capital purposes.

While much depends on the exact situation of each particular distressed company in question, it is noted that this need not necessarily always be the case. There are generally two main tests for insolvency: (i) balance sheet insolvency; and (ii) cash flow insolvency.[49] The former occurs where a company is held to be insolvent because its liabilities exceeds its assets, while the latter occurs where a company is unable to pay its debts as they become due. In the case of the former, it is more likely that the distressed company has more accumulated losses and expenses that it can set off against any income from the forgiven loans. However, in the case of the latter, it is well possible that the distressed company may be making profits and have little losses and expenses to set off the income from the forgiven loans against. The distressed company may just be facing temporary cash flow issues. In any case, it is not immediately clear that forgiven loans will never give rise to tax liabilities in practice, and the possibility is not a particularly fanciful one to be written off immediately.

As the main problem with a distressed company is likely to be an immediate cash flow issue, there are two main approaches which can be taken with respect to the taxation of such income: (i)

[49] For a detailed analysis of these general concepts of insolvency, see Roy Goode, *Principles of Corporate Insolvency Law* (Sweet & Maxwell, 4th ed, 2011) 109-47.

exemption; or (ii) deferment. In the case of the former, any tax payable on the loan is simply exempted and need not be paid, while in the case of the latter, the tax payable may be deferred until a later time where the company is in a better financial situation to make the payment. While both approaches are technically possible, we suggest, based on a review of other comparable jurisdictions that an exemption of such income may be a better approach.

B *The Treatment of Haircuts in Other Restructuring Hubs Around the World*

The UK and the US have traditionally been considered attractive centres for debt restructuring. The UK scheme of arrangement, sometimes in conjunction with other formal insolvency proceeding (creditors' voluntary agreement or administration), has been a powerful restructuring tool in the past decades. In fact, many companies from Continental Europe even went to restructure their debts in the UK in order to take advantage of the scheme of arrangement.[50] The success of the US Chapter 11 has been even more considerable.[51] The best proof of this is that many countries around the world, including Singapore, the European Union, and the UK have implemented (or are planning to implement) several features of the US Chapter 11.[52]

In our opinion, the success of these countries in the restructuring arena is not only due to good laws on the books but also attributable to good laws in action. The sophisticated judiciary existing in the UK and the US have played a major role. Moreover, both countries have addressed the problem of a corporate reorganisation from an interdisciplinary perspective, and therefore not only amended the insolvency framework but also other rules potentially affecting the success of a corporate reorganisation. Among these rules, it seems particularly relevant for the purpose of our article, the analysis of the tax treatment of haircuts existing in the UK and the US.

In the US, a haircut is considered taxable income. However, there is an exception in cases of haircuts agreed as part of a Chapter 11 reorganisation procedure.[53] Therefore, debtors emerging from a corporate reorganisation in the US will not have to pay for those taxes associated with a potential haircut existing in the reorganisation agreement. As a result, they will be able to emerge from bankruptcy in a healthier financial position.

In the UK, a similar provision applies. Section 322 of the Corporation Tax Act 2009 provides that in the case of a statutory insolvency arrangement, where a liability to pay an amount under a

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[50] For example, *La Seda de Barcelona* and *Metrovacesa*. See Horst Eidenmuller, 'The Rise and Fall of Regulatory Competition in Corporate Insolvency law in the European Union' (2019) 20 *European Business Organization Law Review* 547.

[51] Some authors, however, have strongly criticised the efficiency of the US Chapter 11. See Mark Roe, 'Bankruptcy and Debt: A New Model for Corporate Reorganization' (1983) 83 *Columbia Law Review* 527; Douglas Baird, 'The Uneasy Case for Corporate Reorganizations' (1986) 15(1) *The Journal of Legal Studies* 127; Lucian A Bebchuk, 'A New Approach to Corporate Reorganizations' (1988) 101 *Harvard Law Review* 775; Douglas Baird and Robert Rasmussen, 'The End of Bankruptcy' (2002) 55 *Stanford Law Review* 751; Elizabeth Warren and Jay Westbrook, 'The Success of Chapter 11: A challenge to the critics' (2009) 107 *Michigan Law Review* 603.

[52] Aurelio Gurrea–Martinez, 'The Future of Reorganization Procedures in the Era of Pre–Insolvency Law' (2020) *European Business Organization Law Review* (Forthcoming) (Ibero–American Institute for Law and Finance Working Paper No 6/2018, Singapore Management University School of Law Research Paper No 34/2019) <https://ssrn.com/abstract=3290366>.

[53] See *Internal Revenue Code*, 26 USC § 108(a)(1)(A) (2017).

company's debtor relationship is released, the company is not required to bring into account a credit in respect of that release.[54]

As for the case of non-statutory insolvency procedures, section 94 of the Corporation Tax Act 2009 provides that:

> (1) This section applies if—
>
> (a) in calculating the profits of a trade, a deduction is allowed for the expense giving rise to a debt owed by the company carrying on the trade,
>
> (b) all or part of the debt is released, and
>
> (c) the release is not part of a F.
>
> (2) The amount released—
>
> (a) is brought into account as a receipt in calculating the profits of the trade, and
>
> (b) is treated as arising in the accounting period in which the release is effected.[55]

In turn, 'statutory insolvency arrangement' is defined in section 259 of the Income Tax (Trading and Other Income) Act 2005 as 'a voluntary arrangement under, or by virtue of, Insolvency Act 1986 (or Scottish or NI equivalents) or a compromise or arrangement under Companies Act 2006, section 895 (or NI equivalent) or any corresponding arrangement or compromise under, or by virtue of, the law of a non-UK jurisdiction.'

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54 See *Corporate Tax Act 2009* (UK) s 322. Section 322 provides as follows:

(1) This section applies if—

(a) a liability to pay an amount under a company's debtor relationship is released, and

(b) the release takes place in an accounting period for which an amortised cost basis of accounting is used in respect of that relationship.

(2) The company is not required to bring into account a credit in respect of the release for the purposes of this Part if condition A, B or C is met.

(3) Condition A is that the release is part of a statutory insolvency arrangement.

(4) Condition B is that the release is not a release of relevant rights and is—

(a) in consideration of shares forming part of the ordinary share capital of the debtor company, or

(b) in consideration of any entitlement to such shares.

(5) Condition C is that—

(a) the debtor company meets one of the insolvency conditions (see subsection (6)), and

(b) the debtor relationship is not a connected companies relationship (see section 348).

(6) For the purposes of this section a company meets the insolvency conditions if—

(a) it is in insolvent liquidation,

(b) it is in insolvent administration,

(c) it is in insolvent administrative receivership,

(d) an appointment of a provisional liquidator is in force in relation to the company under section 135 of the Insolvency Act 1986 (c. 45) or Article 115 of the Insolvency (Northern Ireland) Order 1989 (S.I. 1989/2405 (N.I. 19)), or

(e) under the law of a country or territory outside the United Kingdom circumstances corresponding to those mentioned in paragraph (a), (b), (c) or (d) exist.

55 See *Corporation Tax Act 2009* (UK) s 94.

C *The Nature of Haircuts and when Preferential Tax Treatment should be Granted*

There are various scenarios in which a haircut can be applied. First, a haircut can be agreed between a debtor and its creditors in a situation of solvency. This haircut will rarely take place, since the creditors would not have incentives to apply a haircut unless a firm is unable to pay its debts and the value of the firm is higher if the firm is kept alive.

Second, a haircut can also be applied to solvent firms facing financial trouble and which are using a purely contractual arrangement (workout) to sort out its financial difficulties. In these cases, the haircut may help solve, at an early stage, those problems that insolvency law seeks to solve. Therefore, there will be more chances to find this type of situations. Third, a haircut can also be granted as part of a formal pre-insolvency or restructuring framework such as a scheme of arrangement. Finally, a haircut can also be granted as part of a full reorganisation procedure such as a judicial management. In these latter cases, the existence of a haircut will be more likely since the creditors will have incentives to give up part of their claims if a firm is economically viable (which they are supposed to be in order to use restructuring procedures, even though it is not necessarily the case in practice),[56] due to the fact that the value of these firms is higher if the company is kept alive. Therefore, creditors can maximise their returns by working together and keeping the firm alive even if, as a way to do so, they would have to give up part of their claims.

In our opinion, several reasons seem to suggest that the favourable tax treatment for haircuts proposed in this article should only be applied in situations 3 and 4. First, from an economic perspective, creditors will rarely have incentives to grant a haircut in situations 1 and 2. In situations 3 and 4, however, creditors should have incentives to grant this haircut if a company is viable but is facing financial trouble. Therefore, there will be a higher risk that debtors use this tax exemption opportunistically in situations 1 and 2.

Second, while situations 3 and 4 involve formal or semi-formal restructuring procedures, situations 1 and 2 describe situations in which the adjustment of debts are part of an entirely private contractual arrangement. Therefore, it will be more difficult for the Government (as the main affected party for a tax exempt) to verify the existence of these financial restructurings. As a result, there will be fewer investigations which may in return lead to more opportunistic use of this exemption by firms.

Finally, by granting this favourable tax treatment to only formal or semi-formal reorganisation procedures, the legislator will incentivise the use of these formal restructuring tools which are supposed to give more certainty and legal protections to all relevant parties.

Therefore, while we find convincing the reasons to implement this tax exemption in countries like Singapore which is seeking to become an international centre for debt restructuring, we think that the benefits of this exemption should be limited to formal or semi-formal reorganisation procedures, that is, to the scheme of arrangement and the judicial management. Otherwise, the

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56 Firms involved in a corporate restructuring are supposed to be economically viable. Otherwise, if the firm is not viable, creditors would not have incentives to negotiate for a corporate reorganisation. Under this scenario, the company should be liquidated. Nevertheless, since, due to several factors (including incentives created by the legislator to promote reorganisation over liquidation, continuation bias, lack of recognition of failure, and sentimental value to the firm) many firms may file for reorganisation even if they are not economically viable, and it can take time to determine whether a company is viable or not, it will be possible to find non-viable firms in corporate reorganisations.

implementation of this provision can be used opportunistically by some debtors seeking to defraud the tax authorities.

V THE NEED TO PREVENT ABUSE

A *A Lack of Tax Symmetry*

While there are benefits from implementing the measures proposed above, it is noted that they do provide certain opportunities for tax avoidance which have to be pre-empted and properly dealt with. The key problem with the measures is that it creates a lack of tax symmetry between the debtor and creditors. Glen Loutzenhiser explains that the tax treatment of the parties to a transaction should generally be symmetrical in order to prevent opportunities for arbitrage.[57] For example, in a transaction between two parties, the transaction would not be symmetrical if the transferring party recorded a capital receipt while the receiving party recorded a revenue expense. This would enable the receiving party to obtain a tax deduction while not recognising the receipt of the transferring party as income. There may be legitimate situations where such treatment is warranted, but the risk of abuse in such situations in the form of arbitrage must be guarded against.

In the present case, exempting the income from the forgiven loans for the debtor means that the debtor is not taxed on that transaction, while the creditor is able to claim a tax deduction on the write-off of that bad debt. However, it is not practical to deny the creditor the tax deduction on that transaction if it was entered into for commercial reasons. The risk of arbitrage in this case may well manifest itself in a round-tripping transaction involving two related companies, where a 'creditor' company lends a 'debtor' company a large amount of money, which it promptly writes off as a bad debt, securing a tax deduction for itself. The 'debtor' company does not have to pay tax on the write-off, leaving the tax authorities out of pocket for the tax deduction, with no corresponding income tax collected. While this is perhaps the most obvious potential form of abuse, it is by no means the only one and steps have to be taken to guard against such abuses. We propose the following safeguards.

B *Limiting Measures to the Case of Insolvency*

As the whole reason for exempting income from forgiven loans in the first place is to help boost the chances of survival of distressed companies and make Singapore an attractive hub for insolvency and restructuring, we submit that this exemption should be carefully confined to situations where a distressed company is undergoing an insolvency and restructuring process. To offer the tax exemption to all other companies generally is to invite abuse and is also likely to have a significant effect on revenue collection in Singapore.

C *Excluding Related Companies from the Measures in Certain Circumstances*

The risk of arbitrage and round-tripping is perhaps the highest where the two companies in question are related. In particular, we note that section 37C of the ITA provides that Singapore companies in the same group may transfer qualifying deductions (including losses) between each

[57] Glen Loutzenhiser, *Tiley's Revenue Law* (Hart Publishing, 9th ed, 2019), [1.3.6].

other.[58] However, incentives to abuse the system still exist even if the related companies cannot directly transfer the qualifying deductions between each other.

Section 34A(2) of the ITA does provide for certain safeguards against abuse in the form of sections 34A(2)(c) and (d) which respectively provide that: '(c) any amount of profit or expense in respect of a loan for which no interest is payable shall be disregarded;' and '(d) where the creditor and debtor of a loan agreement are not dealing with each other at arm's length, only the interest income or the interest expense based on the contractual interest rate shall be chargeable to tax or allowed as a deduction, as the case may be.'

However, these safeguards may be easily circumvented by the creditor and debtor companies agreeing to contract at arm's length, which would by no means dissuade them from engaging in arbitrage, given the substantial incentives involved. In light of this, we propose to adapt the current 'substantial shareholder' condition currently provided for in section 37(12) and the test laid out in section 37(14) of the ITA. This would mean that the creditor and debtor would be deemed to be related companies and unable to take advantage of the measures if the shareholders of one company are substantially the same as the shareholders of the other company.[59]

D *A General Anti-Avoidance Rule ('GAAR')*

The ITA already has an extremely robust GAAR in the form of section 33. It provides that where a taxpayer enters into an arrangement, which purpose or effect is directly or indirectly to obtain a tax benefit, the Comptroller of Income Tax may ignore such arrangements and tax the taxpayer as if he had not entered into such an arrangement.[60] However, the taxpayer may resist the exercise of this power if the arrangement was 'carried out for *bona fide* commercial reasons and had not as one of its main purposes the avoidance or reduction of tax.'[61]

Following the principles laid down by the Court of Appeal in *CIT v AQQ*, the 'predication principle' would first apply, meaning that 'an arrangement would not be predicated as a tax avoidance arrangement if the arrangement is capable of explanation by reference to ordinary business or family dealing, without necessarily being labelled as a means to avoid tax.'[62] This is to be assessed objectively. Following that, the question of whether 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 would be assessed subjectively, with the court assessing this, *inter alia*, by reference to objective evidence.[63]

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58 For more details, see IRAS, *IRAS e-Tax Guide: Group Relief System* (6 September 2011).

59 See ITA s 37(4). Section 37(14) provides as follows:
For the purposes of subsection (12) —
(a) the shareholders of a company at any date shall not be deemed to be substantially the same as the shareholders at any other date unless, on both those dates, not less than 50% of the total number of issued shares of the company are held by or on behalf of the same persons;
(b) shares in a company held by or on behalf of another company shall be deemed to be held by the shareholders of the last-mentioned company; and
(c) shares held by or on behalf of the trustee of the estate of a deceased shareholder or by or on behalf of the person entitled to those shares as beneficiaries under the will or any intestacy of a deceased shareholder shall be deemed to be held by that deceased shareholder.

60 ITA s 33(1).

61 ITA s 33(3)(b).

62 *CIT v AQQ* [2014] 2 SLR 847 ('CIT v AQQ'), [47].

63 Ibid [71], [82].

It is submitted that, having crafted specific anti-avoidance provisions to pre-empt the most obvious potential abuses of the proposed measures, the GAAR in section 33 should suffice to catch other abuses that may not be readily foreseeable at the point of drafting the relevant statutes. The success of the IRAS in invoking section 33 of the ITA to date[64] suggests that it should be robust enough to foil attempts at abusing the measures for purposes not intended by Parliament.

VI CROSS-BORDER INSOLVENCY AND TAX TREATMENT OF HAIRCUTS IN FOREIGN JURISDICTIONS

The new restructuring framework implemented in Singapore is expected to attract foreign companies interested in making use of an insolvency framework that might be more attractive than those existing in their home jurisdictions. However, if their tax regimes do not provide them with any exemptions to the haircuts potentially included in a reorganisation plan reached in Singapore, they may be less incentivised to come to Singapore for a financial restructuring. Therefore, this outcome can not only hamper Singapore's goal of becoming a hub for debt restructuring but it can also be harmful for companies and creditors interested in making use of a more efficient insolvency framework.[65] For this reason, we believe that the tax reform suggested in this paper should not only be implemented in Singapore but also in other jurisdictions where haircuts are still taxable as regular income.

VII CONCLUSION

Singapore has managed to implement one of the most sophisticated restructuring frameworks in the world. However, it has been argued that, due to the taxation of the income generated by a haircut agreed or even imposed in a financial restructuring, many companies may still face liquidity problems after emerging from an insolvency or restructuring procedure. For this reason, in order to maximise the potential of the new restructuring framework implemented in Singapore, not only for the benefit of the local economy but also for the purpose of facilitating the use of a restructuring framework by foreign debtors and creditors that might be more efficient than those potentially existing in their home jurisdictions, haircuts agreed or imposed as part of a financial reorganization should not be taxable.

64 See generally *CIT v AQQ* (n 42), *GBF v CIT* (2016) MSTC 50-019, and *GCL v CIT* (2020) MSTC 50-100.

65 This can be particularly harmful for emerging markets since their unattractive insolvency framework may harm entrepreneurship, innovation and access to finance. Therefore, by allowing them to have access to more attractive insolvency frameworks, these countries will be able to boost their economics. See Aurelio Gurrea–Martinez, 'Insolvency Law in Emerging Markets' (20 May 2020) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3606395>.