

Singapore

Hong Beng Tay

KPMG in Singapore

Tel: +65 6213 2565

email: hongbengtay@kpmg.com.sg

Kok Shang Lam

KPMG in Singapore

Tel: +65 6213 2596

email: kokshanglam@kpmg.com.sg

36

Introduction

Singapore operates a semi-territorial basis of taxation. In accordance with Section 10 of the Singapore Income Tax Act ("SITA"), income tax is imposed on income which has its source in Singapore. In respect of income sourced outside Singapore (foreign sourced income), it is subject to Singapore income tax only when it is received or deemed received¹ in Singapore unless otherwise exempt² under the SITA. Only income of a revenue nature is taxable in Singapore and Singapore does not levy tax on capital gains.

General rules

Broadly, the taxation of derivatives will be based on the general principle of whether the gains or income derived from derivatives are revenue or capital in nature. Generally, the gain will be regarded as revenue in nature if the transaction is entered into as part of the taxpayer's trading activities.

Where the derivatives are entered into as part of the taxpayer's trade/business or are speculative in nature, any gain arising there from would generally be regarded as revenue in nature and subject to Singapore income tax at 18 percent (with effect from Year of Assessment 2008). There are various tax incentives available in Singapore where the gains derived from derivatives may be taxed at concessionary tax rates subject to conditions (see "Special rules" for more details).

On the other hand, where the derivatives are entered into for the purpose of hedging the financial risks of the taxpayer (e.g. foreign currency risk, interest rate risk), it is generally accepted by the Inland Revenue Authority of Singapore ("IRAS") that such gain or loss arising from the derivatives would follow the tax treatment of the underlying transactions. For example, where financial derivatives are used to hedge underlying transactions which are regarded as capital in nature for the purpose of Singapore income tax, any gain/loss arising from such financial derivatives will be treated as capital in nature and will not be taxable or tax deductible.

Specific rules have been put in place in the Singapore income tax legislations to provide guidance on the timing of Singapore income tax on any gain arising on derivatives. These rules are discussed in the next section under "Special rules".

¹ Under Section 10(25) of the SITA, income derived from outside Singapore would be deemed as received in Singapore (and thus taxable in Singapore with certain exceptions) under the following conditions:

- The foreign-sourced income is remitted to, transmitted, or brought into Singapore
- The foreign-sourced income is applied in or towards the satisfaction of any debt incurred in respect of a trade or business carried on in Singapore; and
- The foreign-sourced income is applied to purchase any moveable property which is brought into Singapore.

² Foreign dividend income, foreign branch profit and foreign sourced service income are exempted from Singapore income tax subject to certain conditions.

Special rules

The special rules concerning the timing of Singapore income tax on the gains arising from the derivatives on revenue account are provided for under Section 34A of the SITA.

Section 34A – Adjustment on Change of Basis of Computing Profits of Financial Instruments

Taxpayers with financial periods beginning on or after January 1, 2005 must comply with Financial Reporting Standard (“FRS”) 39 for accounting purposes. With the introduction of FRS 39 for accounting purposes, taxpayers must reflect their financial assets and liabilities (including financial derivatives) at market values in their financial statements. Generally, for Singapore income tax purposes, the income tax treatment will be aligned with that of the accounting treatment³ under FRS 39 for financial assets and liabilities on revenue account.

Derivatives are generally regarded as financial assets under FRS 39. Where derivatives are held for trading or speculative purposes, any gain or loss resulting from the annual re-measurement of the fair value of these derivatives as reflected in the Profit and Loss Account for the relevant year will be subject to Singapore income tax or allowed as a tax deduction. This is notwithstanding that such gain or loss may not be realized.

Where derivatives are for hedging purposes and the underlying asset or liability is on revenue account (e.g. trading securities), any fair value gain or loss will be subject to Singapore income tax or allowed as a tax deduction. However, where the derivatives are used to hedge against underlying asset or liability which is on capital account, any gain or loss from fair value adjustments will be excluded for Singapore income tax purposes.

The following tax incentives are available in relation to derivatives transactions:

Financial Sector Incentive Scheme (Section 43Q of the SITA)

To encourage the development of high-growth and high value-added financial activities in Singapore, the Financial Sector Incentive (“FSI”) scheme was introduced on January 1, 2004.

Under the FSI scheme, qualifying activities are categorized into Enhanced Tier (“ET”) and Standard Tier (“ST”) qualifying activities. Income derived from these qualifying activities is subject to income tax at the concessionary rate of 5 percent and 10 percent under the ET and ST awards, respectively.

ET qualifying activities refer to that of high growth and high value-added financial activities. Such qualifying activities are classified under the following ET awards:

- Bond market (“FSI-BM”)
- Derivative market (“FSI-DM”)
- Equity market (“FSI-EM”)
- Credit facilities syndication (“FSI-CFS”)
- Project financing (“FSI-PF”); and
- Islamic finance (“FSI-IF”).

The ST qualifying activities generally cover a broad range of financial activities that are important to Singapore’s financial sector development objectives.

The relevant tax incentives for derivatives are provided for under the FSI-DM and FSI-ST awards.

Income derived by a FSI-DM company from trading in qualifying derivatives or providing services as an intermediary in connection with transactions relating to qualifying derivatives shall be taxable at 5 percent.

Qualifying derivatives mean financial derivatives that are transacted over-the-counter. Financial derivatives are defined under the Income Tax (Concessionary Rate of Tax for Financial Sector Incentive Companies) Regulations 2005 as derivatives the payoffs of which are linked, whether in whole or in part, to the payoffs or performance of any financial assets, securities, financial instruments or indices, but excludes derivatives the payoffs of which are wholly linked to the payoffs or performance of commodities. It is proposed in the Budget 2008 announcements that with effect from February 16, 2008, the FSI-DM incentive will be expanded to include any income derived from the trading of exchange-traded financial derivatives. Further details on the proposal is expected to be provide by end May 2008.

A company with FSI-ST award shall be chargeable with tax at the concessionary rate of 10 percent on income derived on or after January 1, 2004 from the following activities:

- i) Trading in derivatives; and
- ii) Transactions in gold bullion, silver bullion or platinum bullion.

³ Under normal Singapore income tax principles, only realized gains or losses arising from the disposal of financial assets are subject to tax or allowed as a deduction if such gain or loss is on revenue account. Where financial assets on revenue account are carried at the lower of cost and market value and a provision for diminution in value is made in the accounts, such provision may be allowed as a tax deduction while any subsequent write-back is taxable.

Approved Commodity Derivatives Trading Company (“CDTs”)(Section 43S of the SITA)

Income derived by an approved CDT from trading in over-the-counter (“OTC”) and exchange-traded commodity derivatives with any specified person or services as an intermediary in connection with transactions relating to OTC and exchange-traded commodity derivatives between specified persons shall be subject to tax at a concessionary tax rate of 5%. In addition, the above concessionary tax rate of 5% is also extended to income derived by an approved CDT from trading in freight derivatives between any specified persons or a shipping enterprise. The above is subject to the satisfaction of certain conditions.

Specific persons include:-

- (a) A financial sector incentive company which is –
 - (i) A bank licensed under the Banking Act (Cap. 19); or
 - (ii) A merchant bank approved under Section 28 of the Monetary Authority of Singapore Act (Cap. 186)
- (b) An approved global trading company
- (c) Another CDT
- (d) A person who is neither a resident of nor a permanent establishment in Singapore
- (e) A branch office outside Singapore of a company resident in Singapore
- (f) A member of the Singapore Commodity Exchange
- (g) An approved oil trading company
- (h) An approved international commodity trading company
- (i) A person who carries on the business of refining petroleum in Singapore; or
- (j) A petrochemical manufacturing company in Singapore which is approved on or after November 1, 1996 by the Minister or such person as he may appoint.

OTC commodity derivatives refer to commodity derivatives that are transacted OTC whose payoffs are linked, in whole, to the payoffs or performance of underlying commodities. This scheme does not cover derivatives whose payoffs are linked, whether in whole or in part, to the payoffs or performance of any underlying financial instruments such as securities, indices or currencies.

Exchange-traded commodity derivatives refer to derivatives that are transacted on exchanges and whose payoffs are linked, in whole, to the payoffs or performance of underlying commodities, including freight rates.

Concessionary rate of tax for futures members of the Singapore Exchange (Section 43D of the SITA)

Income derived from the following by a futures member of the Singapore Exchange shall be taxable at the concessionary tax rate of 10 percent:

- (a) Income derived from transactions in gold bullion or in any commodity or financial futures on any approved exchange or in any approved market with, or derived from any foreign exchange transaction with: —
 - (i) A bank licensed under the Singapore Banking Act, or a merchant bank approved by the Monetary Authority of Singapore, which is a FSI company
 - (ii) Another futures member of the Singapore Exchange;
 - (iii) A person who is neither a resident of, nor a permanent establishment in, Singapore
 - (iv) A branch office outside Singapore of a company resident in Singapore; or
 - (v) A foreign investor where such transaction is carried out through a financial sector incentive company
- (b) Income derived from transactions in any petroleum futures on any approved exchange with an oil trading company approved under the SITA.

Withholding tax (WHT)

For Singapore income tax purposes, any payments of interest, commission, fee or any payment in connection with any loan or indebtedness or with any arrangement, management, guarantee, or service relating to any loan or indebtedness to be derived from Singapore if the payments are borne directly, or indirectly, by a person resident in Singapore, or a permanent establishment in Singapore (except in respect of any business carried on outside Singapore through a permanent establishment outside Singapore), or are deductible against any income accruing in or derived from Singapore, are deemed to be sourced from Singapore.

Any person making a payment to another person not known to him to be resident in Singapore is obliged to withhold tax at the domestic withholding tax rate of 15 percent unless mitigated or exempted under a special concession or any relevant tax treaties that Singapore has entered into with other countries.

This rate is relevant where the income is not derived by the non-resident person through its operations carried out in or from Singapore. Where such operations are carried out in or from Singapore, tax has to be withheld at 18 percent (with effect from January 1, 2007) in respect of payment made to a non-tax resident (other than individuals).

If such payments are made to non-Singapore tax resident individuals, the withholding tax rate is 20 percent.

Although derivatives arrangements are generally notional principal contracts, it is not clear in the SITA whether such payments under a financial derivatives arrangement would be seen to be in connection with indebtedness and hence subject to Singapore withholding tax.

Nevertheless, under the Income Tax (Exemption of Interest and Other Payments for Economics and Technological Development) (No.2) Notification 2007 as conferred under Section 13(4) of the SITA, an income tax exemption is granted for all over-the-counter ("OTC") financial derivatives payments made during the period May 20, 2007 to May 19, 2012 (both dates inclusive) by financial institutions and approved securitization vehicles to a person who is neither resident in Singapore nor a permanent establishment in Singapore under a contract for such derivatives which took effect before February 15, 2007 or a contract for such derivatives which is extended or renewed, where the extension or renewal took effect before February 15, 2007.

The above exemption was also extended to all payments made in relation to contracts which are entered into during the period February 15, 2007 to May 19, 2012 or where the contract for such derivatives is extended or renewed, where the extension or renewal takes effect during the period February 15, 2007 to May 19, 2012. In other words, any payment made by a financial institution during the life of such an OTC financial derivative contract entered into between February 15, 2007 and May 19, 2012, to a person who is neither resident in Singapore nor a permanent establishment in Singapore, will be exempt from Singapore withholding tax.

However, based on the 2008 Budget Announcements, it is currently not clear whether the above withholding tax exemption would be expanded to include exchange-traded financial derivatives. Further details are expected to be available by end May 2008.

In addition, the Minister for Finance has granted a remission of withholding tax on all interest paid on interbank and interbranch transactions by approved banks in Singapore. This remission has been subsequently extended to include fees, commissions and other payments related to indebtedness, apart from interest, liable to Singapore income tax.

Indirect tax/Goods and Services Tax (GST)

Generally, pursuant to the Singapore GST legislation, the supply of financial services including derivatives to a person belonging in Singapore or which are traded through the local exchange is GST exempt for which the input GST attributable to such supplies are not recoverable.

However, if these derivatives are supplied to a person belonging outside Singapore or which are traded through the overseas exchanges, the supplies would be zero-rated. In this case, the input tax credits attributable to such supplies are recoverable.

Any services consisting of arranging, broking, underwriting or advising on derivatives in return for a brokerage fee, commission or other similar consideration would be subject to GST either at standard-rate or zero-rate (i.e. taxable supplies) depending on the belonging status of the client.

The provision or assignment of futures contracts which does not lead to a delivery of the underlying commodities is GST exempt. Nonetheless, if there is a delivery of the underlying commodities (e.g. oil) at maturity, there is a separate supply of goods which is taxable at a standard-rate of 7 percent if the delivery takes place in Singapore.

Call and put options are treated in the same way as the futures contracts above. The premium received by the GST-registered seller of the option is GST exempt. There is no further supply for GST purposes where a call or put option is exercised to obtain or provide the underlying financial futures contracts.

Stamp Duty

Stamp duty is payable only on documents relating to immovable property, stocks and shares. These include sales, mortgages or lease of properties as well as transfer or mortgage of shares.

Generally, derivatives contracts are not subject to any stamp duties.

Typical transaction

Set out below is a typical derivative transaction that a Singapore-based bank may enter into together with an overview of the Singapore tax consequences.

Facts:

1. A subsidiary outside Singapore of a United States Multinational Company (hereafter known as SubCo), has entered into a US\$ denominated borrowing with its head office. The US\$ denominated borrowing will be repaid one year later.
2. SubCo's base currency is Singapore dollars and enters into cross currency swap with a Singapore Bank to hedge against the foreign currency risk and interest rate risk of the US\$ denominated borrowing. At the inception of the swap, there would be an initial exchange of the US\$ loan principal amount by SubCo into Singapore dollars ("S\$") with the Singapore Bank.
3. Assuming that SubCo is required to make monthly interest payment of the loan in US\$, every month, SubCo would receive US\$ (equivalent to the payment due under the borrowing) from the Singapore Bank and pay the Singapore Bank a pre-determined amount in S\$.
4. At maturity, SubCo will receive an amount in US\$ equivalent to the loan principal due under the borrowing and pay the Singapore Bank a pre-determined amount in S\$.
5. Singapore Bank will enter into a foreign currency swap to hedge its exposure to US\$ with another Bank outside Singapore.
6. Singapore Bank would 'fair value' the total return swap and the hedge under normal FRS 39 accounting principles.

Singapore tax treatment for Singapore Bank:

1. Any gain or loss arising from the fair value adjustment of the cross currency swap should be treated as revenue in nature as it forms part of the Singapore Bank's trade. Accordingly, the gain/loss on the cross currency swap should be taxable/deductible in the books of the Singapore Bank at 10 percent (on the premise that the Singapore Bank is able to benefit from the FSI-ST award).
2. The foreign currency swap of the US\$ should generally follow the underlying transaction which in this case is the cross currency swap transaction entered into by the Singapore Bank with SubCo. In this regard, any gain or loss arising from the annual re-valuation of the foreign currency swap under FRS 39 will also be treated as revenue in nature and subject to Singapore income tax/allowed as tax deductions.
3. No Singapore withholding tax should be payable on the payments made by Singapore Bank under the cross currency swap and the foreign currency swap to Sub Co and foreign bank in view of the income tax exemption for OTC financial derivatives and inter-bank/inter-branch remission of withholding tax.

Singapore GST treatment for Singapore Bank:

1. Pursuant to Singapore GST legislation, a cross currency swap is an exempt supply. However, as the said supply also falls within the description of an international service on the basis that the counter party to the transaction is the SubCo, an entity belonging outside Singapore, the supply is zero-rated.
2. Notwithstanding the above, the Singapore Bank is not required to report the value of zero-rated supplies arising from this transaction in its GST F5 return as banks in Singapore are currently given the administrative practice concession not to report the value of zero-rated supplies in their GST returns.
3. The Singapore Bank is allowed to claim a portion of the GST incurred in respect of this transaction. This is because banks in Singapore are currently accorded by the IRAS with fixed input tax recovery percentage for a GST tax year based on the type of license that they are holding. This fixed input tax recovery percentage is updated by the IRAS every GST tax year. For instance, if the Singapore Bank is licensed to operate as a merchant bank in Singapore, it can claim 96 percent of the GST incurred on transaction as its input tax credits.