

# **Singapore: Financial Institutions and Instruments**

## **– Tax Challenges and Developments**

### **1 Introduction**

- 1.1 The Singapore financial sector is a well regulated sector. IRAS as the tax authority plays a complementary role in ensuring that tax rules and laws are kept in tandem with the growth and development of the financial sector. In keeping with the growth and development of the financial sector in Singapore, financial institutions and financial instruments have grown increasingly sophisticated. Financial instruments and products have also evolved rapidly. Financial instruments such as derivatives can be innovatively structured in various forms with different levels of complexity. A more complex form of derivative includes a hybrid financial instrument that comprises both the derivative and a host contract (i.e. embedded derivatives). These developments, amongst others, are triggers for IRAS to constantly keep abreast of the changes in the financial sector and consider the relevant issues and challenges that can potentially arise from such changes.
- 1.2 This paper provides a broad overview of IRAS's experience in the taxation of financial institutions and instruments, and in addressing the challenges faced in this area.

### **2 Taxation of Financial Institutions and Instruments**

- 2.1 The tax treatment of financial institutions and instruments in Singapore follows broadly the general principles of taxation which encompass all forms of trades and activities. There is no capital gain tax in Singapore and only income or gain of a revenue nature is subject to tax.
- 2.2 Financial institutions are generally taxed like any other normal company in Singapore. A financial institution, regardless of whether or not it is a tax resident of Singapore, is taxed on its income accruing in or derived from Singapore as well as its income received in Singapore from outside Singapore. Income derived by a financial institution in Singapore would generally be subject to tax at the prevailing corporate tax rate of 18%, unless it is granted a specific tax incentive on specific income.
- 2.3 Under the general principles of taxation in Singapore, income is generally taxable on a realisation basis. In this regard, of relevance to financial institutions and instruments is that prior to the introduction of the Financial Reporting Standard ("FRS") 39<sup>1</sup> tax treatment (see paragraph 3.4.2 for details on FRS 39 tax treatment), for income tax purposes, only realised gains or losses are subject to tax or allowed as a deduction where such gains or losses are derived or incurred on revenue account (with the exception of the provision of loss in value of trading assets which is deductible for tax purposes). In addition, apart from certain financial products or instruments, there is no specific legislation under our domestic tax law that deals categorically with the taxation of financial institutions and instruments.

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<sup>1</sup> FRS 39 is issued by the Accounting Standards Council in Singapore which prescribes accounting standards for Singapore-incorporated companies, charities, cooperative societies and societies.

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2.4 Notwithstanding the above, the taxation of different financial institutions and instruments may not be synonymous, depending on the profile and activities carried out by the financial institution concerned or the nature and form of the instrument concerned. Even within any particular financial institution, more than one tax treatment may be applicable, depending on the type of activities that is carried out, the nature or income attributable to the financial institution.

2.5 As stated above, apart from the application of broad taxation principles to determine the tax treatment of financial institutions and instruments in general, our domestic tax law also prescribes specific tax treatment in relation to certain financial products or financing arrangements. The tax treatments of some key financial products and financing arrangements are briefly set out in the subsequent paragraphs.

### **2.6 Qualifying Debt Securities**

2.6.1 The Qualifying Debt Securities (“QDS”) scheme was introduced in the late 1990s to promote the development of Singapore’s debt market. The QDS scheme accords certain concessionary income tax treatment to qualifying income arising from debt securities that qualify as QDS. Under this scheme, qualifying non-resident and individual investors are exempt from tax on qualifying income from QDS while qualifying resident non-individual investors are subject to tax at a concessionary rate on qualifying income from QDS.

2.6.2 The QDS scheme was enhanced in 2008 to provide tax exemption on qualifying income derived by any investor from QDS (excluding Singapore Government Securities), subject to conditions.

### **2.7 Prescribed Islamic Financing Arrangements**

2.7.1 Singapore’s overall policy for the tax treatment of Islamic financial services is to align the tax treatment of Islamic financing contracts with the tax treatment of conventional financing contracts that they are economically equivalent to. In this regard, tax rules are prescribed for several specific Islamic financial arrangements based on specific Islamic concepts, for example Murabaha and Ijara-wa-igtina, to provide the industry with maximum flexibility for innovation while preventing any unintended tax consequence.

2.7.2 To encourage more Islamic financing activities to be done out of Singapore, in 2008, a concessionary tax rate was granted on qualifying income from certain qualifying Islamic financial activities, subject to similar conditions imposed in respect of conventional financial activities that such Islamic financing activities are economically equivalent to. This tax concession will expire by 31 March 2013.

## **3 Understanding and Addressing Developments/Challenges from Financial Sector**

### **3.1 Operations of Financial Institutions**

3.1.1 Financial institutions, by the nature of their business and activities, constitute complex taxpayers for many tax authorities including IRAS. It is important for tax assessors to possess a good knowledge and understanding of the activities and transactions carried

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out by financial institutions to be able to identify and be mindful of the issues and risk areas in the assessment of such entities. It is therefore critical for IRAS to continuously keep up with the developments in the financial sector to better understand the issues and risks involved in the review and assessment of financial institutions. The paragraphs below highlight some of the programs and approaches that IRAS has adopted to cope with the challenges.

### **3.2 Enhanced Relationship with Taxpayers**

- 3.2.1 IRAS has embarked on an enhanced relationship programme with some of the large taxpayers including financial institutions. This is in recognition of the fact that there is a need to gain a more holistic view of these taxpayers to better understand their business model and products, facilitate risk assessment and expedite tax issue resolution, given that such taxpayers generally have more complex business structures, operations and/or products that frequently carry with them significant tax risks and issues. The enhanced relationship program is an integral part of the overall strategy to better facilitate and improve tax compliance among our taxpayers.
- 3.2.2 As part of this programme, tax assessors seek to understand the taxpayers' business, identify the potential compliance risks and actively engage taxpayers for resolution of the issues identified. Through a deeper understanding of the taxpayers' business and operations, tax assessors seek to ensure compliance by taxpayers.

### **3.3 Regular Industry Dialogues**

- 3.3.1 IRAS believes in building a strong partnership with taxpayers through open communication and regular feedback. Regular industry dialogues with the financial institutions or their representative bodies such as the Association of Banks in Singapore are held on a regular basis. These industry dialogues provide the platform for mutual exchange of issues and emerging challenges for tax. IRAS also uses the platform to seek feedback and information on the various financial-related issues and industry trends. We are able to obtain more in-depth knowledge of the activities and transactions carried out by financial institutions in Singapore as well as building our relationship with the financial sector.
- 3.3.2 As the Singapore financial sector is well regulated, it is pertinent that IRAS also works closely with other regulatory authorities and government agencies to ensure that the tax system and tax treatment keep in tandem with the regulatory environment for the financial sector. IRAS holds regular dialogues with these agencies to keep a close watch on developments in the regulatory environment.

### **3.4 Financial Reporting Standards**

- 3.4.1 The Singapore's Financial Reporting Standards are also being updated regularly in keeping with the development in global financial reporting standards to ensure strong governance, robust reporting and public accountability. As a principle, IRAS aligns the tax treatment with the accounting treatment where relevant. Apart from consistency, this eases compliance for taxpayers.
- 3.4.2 As an example, arising from the changes in accounting standards and the adoption of FRS 39 for accounting purposes from 1 January 2005 by companies in Singapore,

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companies are presently required to reflect their financial assets and liabilities at market values in their financial statements. In this regard, to minimise tax adjustments which the taxpayers would face and ease the compliance burden for taxpayers, IRAS has modified the taxation of financial assets and liabilities to be aligned generally to the accounting treatment (“FRS 39 tax treatment”). This essentially means that unrealised gains or losses of an entity that is required to adopt the FRS39 accounting treatment can be subject to tax or allow as a deduction where such gains or losses are derived or incurred on revenue account. This is a deviation from the normal general taxation principle. Notwithstanding the introduction of the FRS 39 tax treatment, companies are allowed to make an irrevocable election to continue with the pre-FRS 39 basis of taxation.

### 3.5 Tax Issues Relating to Hybrid Financial Instruments

3.5.1 Financial instruments were traditionally classified as either debt or equity in nature. Debt instruments typically provide the investor a constant return at a specified rate that is usually known to the investor upfront i.e. interest. On the other hand, equity instruments allow for participation in the profits of the investee and the income payout from such participation culminates in the form of dividends in the hands of the investor. The tax treatment for interest and dividend is distinct and unambiguous. For tax purposes, interest expense is generally deductible in the hands of the payer (if such expense is wholly and exclusively incurred in the production of the income of the payer) while dividend payment is not deductible. Conversely, interest income is generally taxable in the hands of the recipient while dividend income (paid by Singapore resident companies) is tax exempt.

3.5.2 Increasingly, as more innovative and complex financial instruments are being introduced, the line between what constitutes a debt or equity instrument becomes somewhat clouded. There is ambiguity as to the real nature or character of a financial instrument that exhibits both features of debt and equity. Examples of such an instrument are certain regulatory capital<sup>2</sup> (such as innovative Tier-1<sup>3</sup> or upper Tier-2 instruments) issued by banks and redeemable preference shares. The ambiguity in the nature or character of such hybrid financial instruments can result in the difficulty of establishing the true character of income or expense arising from such instruments. Consequently, characterising the nature of such instruments and their resulting income and expense in one way or another can lead to different tax outcomes, which in turn may open up opportunities for tax arbitrage. This can result in potential tax abuse of hybrid instruments, which IRAS needs to be mindful of.

3.5.3 IRAS has implemented an environmental scanning framework which requires the tax specialists to scan the environment for best practices, rulings and case laws to build up

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<sup>2</sup> Regulatory capital of a bank can be divided into core capital (Tier 1 capital) and supplementary capital (Tier 2 capital). Tier 1 capital consists of shareholders' funds (equity capital and disclosed reserves), and innovative capital instruments that closely resemble the characteristics of shareholders' funds. Tier 2 capital may consist of revaluation reserves, unencumbered general provisions, and funds raised from issuance of subordinated debt instruments.

<sup>3</sup> As an illustration, in the case of innovative Tier-1 capital, such capital forms part of the overall capital structure of the bank. Nonetheless, it may be regarded as debt for tax purposes (provided certain features are present such as fixed payout, redeemable and step-up features), and this allows the bank to obtain a deduction for the cost of paying interest on such capital. Accordingly, it is more attractive for banks to issue innovative Tier-1 capital than issuing additional shares as dividends paid on shares are not tax deductible.

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knowledge for the development of appropriate tax treatment. IRAS also seeks information on other tax jurisdictions' tax treatment where relevant. This allows the development of tax treatment and rulings that are consistent with global practices.

### **3.6 Cross-Border Transactions**

- 3.6.1 The continued expansion of international trade and global markets and the ever increasing cross-border transactions can result in complex tax issues for both businesses and many tax authorities including IRAS. Different tax jurisdictions can treat the nature and characterisation of a payment arising from the same cross-border transaction or instrument differently depending on the domestic tax law and system. The disparity in the treatment of the same instrument or payment for tax purposes by different tax jurisdictions may result in double taxation or unfavourable tax outcome for taxpayers. This can lead taxpayers not being able to enjoy treaty benefits to the fullest extent and possibly more Mutual Agreement Procedure cases.
- 3.6.2 On the other hand, the differences of the tax treatment for the same instrument in different tax jurisdictions may potentially result in cross-border tax arbitrage opportunities where the taxpayer can engage in aggressive tax planning and structure his transaction or instrument accordingly to take advantage of the differences between various tax jurisdictions' tax rules and systems to obtain a more favourable tax outcome.
- 3.6.3 Hence, it is important for IRAS to recognise and understand potential cross-border tax issues and implications associated with financial institutions and instruments which generally are likely to transcend beyond national boundaries, and be able to respond appropriately to such issues. IRAS is also strengthening her resources and capacity to handle more cross-border tax issues.

## **4 Moving Ahead**

- 4.1 The challenge for IRAS remains to be how Singapore's tax system could stay competitive so as to provide a conducive operating environment for the financial institutions in Singapore, and to be equipped to deal with the issues and risks associated with the businesses and activities carried out by financial institutions appropriately. It is therefore important for IRAS to constantly keep abreast of the changes in the financial sector given the rapid evolvement of financial instruments and products, and to develop an apt approach towards the taxation of financial institutions and innovative financial instruments in Singapore.