

Financial Services Tax Bulletin

Withholding tax exemption for
specified entities

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Despite the relative lack of attention paid to multi-nationals in Singapore's Budget 2011 than in previous years, the financial services sector continues to be a beneficiary with measures introduced to simplify tax rules and ease compliance. One of them is the withholding tax exemption granted to specified financial institutions on interest and related payments. Details of the scheme were released on 31 March 2011 in the Monetary Authority of Singapore's (MAS) FDD Cir 02/2011. Below, we examine some of the finer points of the scheme.

In positioning itself as a leading international financial centre in Asia, Singapore has been extending a wide range of tax concessions to the banking sector over the years. Undoubtedly, one of the more important concessions is the interest withholding tax exemption.

Starting with the primary source of the law, this is what Singapore's Income Tax Act (the "Act") says about such payments:

There shall be deemed to be derived from Singapore –

- (a) any interest, commission, fee or any other payment in connection with any loan or indebtedness or with any arrangement, management, guarantee, or service relating to any loan or indebtedness which is –*
 - (i) 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 any immovable property situated outside Singapore; or*
 - (ii) deductible against any income accruing in or derived from Singapore; or*
- (b) any income derived from loans where the funds provided by such loans are brought into or used in Singapore.*

As can be seen, section 12(6)(a) is a widely worded provision. It deems not just interest, but also commissions, fees or any payments of a similar nature connected with any loan or indebtedness (collectively referred to as "interest and related payments"), borne by a resident or permanent establishment (PE), or deductible against Singapore-sourced income, to be sourced in Singapore.

Section 12(6)(b), on the other hand, deems income derived from loans, where the funds from those loans are brought into or used in Singapore, to be derived from Singapore. So if a person enters into a loan agreement with a non-resident and uses the funds from the loan to pay another person in Singapore, the amount borrowed to pay that other person in Singapore would be considered as being used in Singapore. This means that interest arising from that loan would be deemed to be derived in Singapore also.

Where an interest payment is caught by section 12(6) and is made to a non-resident (including a PE a non-resident might have in Singapore), the payer is obliged to withhold tax on the gross amount,¹ unless an exemption applies.

¹ Section 45 of the Act.

Thus far...

Historically, by way of remission, banks in Singapore, resident or otherwise, were exempted from having to account for withholding tax on interest and related payments made to their branches, head office, or other non-resident banks outside Singapore. This is a blanket remission for all approved banks² with no conditions or sunset clause.

There are many other tax exemptions or remissions in place for interest and related payments on specific transactions. For instance, interest derived from qualifying debt securities and income from structured products (as defined) is tax exempt where conditions are met. Further, interest withholding tax does not apply to, among other things, payments under a cross currency swap transaction or an interest rate or currency swap, a securities lending or repurchase arrangement, as well as payments in respect of over-the-counter financial derivatives, when made to certain non-residents by specified Singapore persons. While they may have been helpful to position Singapore as a financial centre, these exemptions often come with different conditions, which in turn introduce a level of complexity in tax compliance (Further, it is doubtful whether some of the payments are liable to withholding tax in the first place. Consider, for instance, *ACC v Comptroller of Income Tax*³, a High Court decision handed down in October 2010, where it was said that interest rate swap payments to non-residents would ordinarily not be subject to withholding tax.)

As yet another initiative to enhance Singapore's competitiveness, the Minister for Finance announced in Budget 2011 that from 1 April 2011, all interest and related payments made by banks and similar financial institutions to non-residents (excluding PEs in Singapore) will be exempt from withholding tax. The rationale is that such institutions are "increasingly tapping funds from non-bank sources such as hedge funds and insurers, which are not covered under the current inter-bank interest withholding tax exemption."⁴

MAS Circular dated 31 March 2011

On 31 March 2011, the MAS issued FDD Cir 02/2011 providing details of this scheme. Broadly, interest and related payments made to non-residents (excluding PEs in Singapore) by "specified entities" for the purpose of their trade or business are exempt from withholding tax from 1 April 2011 for a period of 10 years.

Non-resident payees

Whether a person is a resident or not is a question of fact and usually, it should not pose a particular difficulty. A PE in Singapore is, typically, a non-resident for Singapore tax purposes. This means that withholding tax is deductible from any interest and related payments made to a Singapore-based PE unless that PE has obtained a waiver from the Inland Revenue Authority of Singapore (IRAS) (which is a separate exercise).

Tenure of scheme

In line with the government's intention to assess the relevance of all tax incentives, this scheme has a sunset clause fixed at 31 March 2021. The withholding tax exemption will therefore apply to interest and related payments liable to be made

² Section 92(2) of the Act

³ [2010] SGHC 316

⁴ Budget speech 2011, paragraph C.73

between 1 April 2011 and 31 March 2021, for contracts which take effect before 1 April 2011. For contracts that take effect between 1 April 2011⁵ and 31 March 2021, the exemption applies to such payments liable to be made for the whole tenure of the contracts, including periods beyond 31 March 2021.

Specified entities

To enjoy the exemption, the payer must be one of the following:

- banks licensed under the Banking Act or approved under the Monetary Authority of Singapore Act (i.e. merchant banks);
- finance companies licensed under the Finance Companies Act; and
- entities that are:
 - holding a Capital Markets Services Licence under the Securities and Futures Act to carry out the regulated activities of "dealing in securities" and "advising on corporate finance";
 - involved or will be involved in the underwriting of debt or equity capital market issues; and
 - approved by the MAS for purposes of this exemption scheme.

Entities that satisfy the conditions under the third bullet point (e.g. investment banks, securities houses) may apply to the MAS for the tax exemption.

Is it for the purpose of one's trade?

When first announced in Budget 2011, it was unclear what the Minister meant by payments made "for the purpose of their trade or business", which arguably should be the case for all borrowings taken by businesses. Incidentally, the same condition is imposed on a similar withholding tax exemption granted for interest and related payments made by approved funds. In that context, it is defined to exclude payments made with the intention of avoiding Singapore tax or payments that relate to the capital structure of the fund.

On this point, the MAS circular simply states that the tax exemption will apply to "all interest payments liable to be made...for the purpose of the trade...of the specified entities unless the interest payments arise from transactions to which [the anti-avoidance section] of the [Act] applies."

It was further clarified by the IRAS at the recent Tax Academy Budget Seminar 2011 that it matters not that the interest payment is incurred for an asset of a capital nature (ie a passive investment business which within the context of the Act, is not taken to be an active trade); the exemption still applies although in the context of the nature of activities typically undertaken by specified entities, such activities are likely to be few and far between. In essence, the withholding tax exemption applies so long as the arrangement is carried out for bona fide commercial reasons and does not have tax avoidance as one of its main purposes. It is not apparent why there is a need for this particular condition, indeed, whether it is a condition at all. All provisions within the Act are in any event subject to the anti-avoidance section.

All for the better?

To a certain extent, this exemption scheme streamlines the various interest withholding tax exemptions already enjoyed by specified entities. It is likely to reduce compliance costs as well as the administrative burden of having to oversee

⁵ Alternatively, it would be the later date on which the entity is approved by the MAS for the purpose of this exemption scheme.

interest withholding tax, though it does not do away the need to monitor closely where there are payments due to PEs in Singapore (and whether the PE has obtained a waiver from the IRAS). This appears to be the one common bugbear of industry players. Some of the interest and related payments go to non-residents with PEs in Singapore. In such cases, the specified entities would still need to rely on the existing tax exemption schemes or to determine whether a waiver has been obtained. Non-specified entities, on the other hand, will need to continue to rely on the array of specific exemptions noted above. For instance, insurers entering into securities lending will still need to rely on an exemption notification issued under the Act.⁶

It is imperative that an entity falling within the third category applies to the MAS to ensure that it is an approved entity for the purposes of the scheme. Based on informal discussions with the MAS, the scheme applies on an entity-basis. What this means is that so long as an entity is an approved entity, the withholding tax exemption applies to payments made for both regulated and unregulated activities. That said, the entity must be able to show that there is substance in its regulated activities – the injection of regulated activities into an entity at a superficial level which was otherwise conducting unregulated activities, purely for the purposes of the exemption, is unlikely to meet with approval.

From a comparative angle, Singapore is playing catch-up with Hong Kong, which never has imposed withholding tax on similar payments. This should be yet another attractive addition to Singapore's enticing tax landscape – for the next 10 years at least.

That aside, the IRAS has clarified that there will be no cut-back to the existing inter-bank inter-branch remission; it will continue without a sunset clause. Also, there are no changes to those tax exemption schemes with their respective sunset clauses.

Which brings us to our final point: why a sunset clause? The Minister explained in his Budget speech that the sunset clause allows the government to review the scheme for its relevance. A decade is a rather long time and arguably does provide certainty to the extent that the expiry date is known right from day one. But it is not as certain as a scheme with no expiry date though in theory nothing stops a government from withdrawing the scheme at short notice. But a sunset clause is what it looks like we will have to live with for now.

⁶ Income Tax (Exemption of Interest and Other Payments for Economic and Technological Development) (No. 3) Notification 2003

Get in touch

Contact us

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