

## A new Singapore tax case to keep a lookout for – withholding tax treatment of interest rate swap payments

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### Background

The Inland Revenue Authority of Singapore (IRAS) issued a practice note in 1998, indicating its position on whether payments made on interest rate or currency swaps to non-residents are subject to withholding tax. Contrary to common industry understanding of such instruments, the IRAS came to the conclusion that all payments on interest rate or currency swaps constituted “payments in connection with any loan or indebtedness” under section 12(6)(a) of the Income Tax Act and were subject to withholding tax when made to non-residents.

This practice note has created uncertainties for financial institutions in Singapore dealing in derivatives with offshore counterparties. This issue has been alleviated to a certain extent with the introduction of various exemptions, the latest being the withholding tax exemption on payments made by financial institutions on over-the-counter financial derivatives. This withholding tax exemption, however, has an expiry date. Furthermore, it remains an issue for Singapore-based counterparties that are not financial institutions, who may then have to bear the withholding tax on such payments.

Something that might bring some excitement to taxpayers in this regard is a recent judgment issued by the Singapore High Court, which came to the preliminary view that payments on interest rate swaps (IRS) are not payments made in connection with any loan or indebtedness.

### Overview of the case

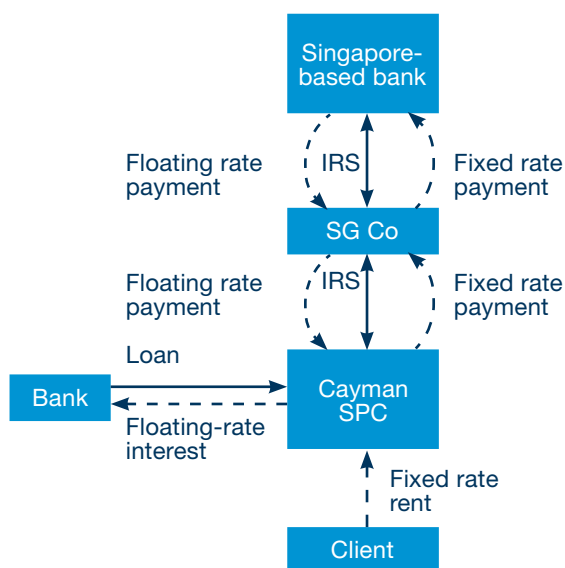
In the case of ACC v CIT ([2009] SGHC 211), a Singapore-incorporated company (“SG Co”) applied for leave to quash the decision of the Comptroller of Income Tax (the “Comptroller”) that withholding tax is applicable on IRS payments made to its non-resident subsidiaries.

Briefly, the facts of the case are as follows:

- SG Co and its overseas subsidiaries were in the business of leasing certain machinery. Most of the subsidiaries were special purpose companies (SPCs) incorporated in the Cayman Islands.
- Each SPC owned only one machine, and each SPC entered into a loan agreement with offshore banks to finance the purchase of its machine.
- In the event that the lease entered into by a SPC was at a fixed-rate rent, the SPC would be exposed to interest rate fluctuations if its financing were at a floating rate. To hedge the interest rate risk exposure in this case, the SPC would enter into an IRS whereby:
  - the SPC would pay the counterparty fixed rate payments computed as a fixed percentage of a notional amount; and
  - in exchange, the counterparty would pay to the SPC on the same dates the floating rate percentages of the same notional amount.

## Tax Bulletin

- To reduce the administrative burden and to dispense with guarantees that SG Co would have to be put up if each SPC were to enter into the IRS separately, SG Co put in place an arrangement whereby it would enter into IRS with Singapore banks or Singapore branches of foreign banks. SG Co will then enter into IRS agreements that mirror these agreements with each SPC.
- The net IRS payments and receipts were recorded in SG Co's balance sheet as "amount owing to/by subsidiary", as the IRS were intended for the SPCs. No tax deduction was claimed by SG Co on IRS payments to the SPCs, and the receipts from the banks on the IRS were not brought to tax.
- SG Co sought confirmation from the Comptroller that withholding tax was not applicable to the IRS payments made by it to the SPCs. The Comptroller responded negatively to the request.
- SG Co then applied to the High Court for leave to apply to quash the determination by the Comptroller.



In deliberating whether to grant leave to SG Co to seek a quashing order, Andrew Ang J had to consider, amongst other things, whether the material put forth disclosed an arguable case or prima facie case of reasonable suspicion in favour of granting the public law remedies sought by the applicant (i.e. SG Co in this case). He came to the preliminary view that the IRS "payments are not made in connection with any loan or indebtedness but for the purpose of hedging risks" on the following basis:

- Neither party to the IRS transaction made any loan to the other so as to give rise to an obligation on the part of the other to pay interest. Thus, IRS payments neither constituted interest nor any other payment in connection with any loan or indebtedness. This is despite the fact that the quantum of the periodic payments to be made by each party was computed in the same way that interest was calculated but in respect of a notional amount.
- It is merely a contractual swapping of cash flows.

He was also of the view that the payments do not appear to be connected with any "arrangement, management, guarantee or service relating to any loan or indebtedness". In view of the above, he granted SG Co leave to seek a quashing order. Andrew Ang J acknowledged that this preliminary analysis of application of section 12(6)(a) to IRS payments should not be taken as a substitute for a determination at the full hearing of the application for a quashing order.

The judge did not go on to analyse SG Co's argument that the IRS payments should nonetheless fall outside section 12(6)(a) on the basis that they were neither borne by SG Co nor deducted against its Singapore-sourced income, which would be left for consideration at the full hearing.

## What are the implications?

In arriving at his decision, the judge made the point that IRS “payments are not made in connection with any loan or indebtedness but for the purpose of hedging risks”. Does this then mean that an IRS entered into for trading purposes would have to be distinguished from one entered into for hedging purposes for application of withholding tax? As pointed out by Andrew Ang J, the crux of the issue is whether the IRS results in any loan or indebtedness between the two parties to the transaction. And since an IRS transaction typically does not create any indebtedness between the parties to it, section 12(6), and consequently the withholding tax provisions, should not apply.

In this case, the judge did not deliberate the questions of whether the words “in connection with” could have a broader meaning, or whether IRS payments could be considered “payments ... in connection with any arrangement ... relating to any loan or indebtedness” under section 12(6)(a). Consider the scenario in which a Singapore company obtained a floating-rate loan from a bank in Singapore. To hedge its interest rate exposure, the Singapore company then enters into an IRS with a bank outside Singapore, under which it made IRS payments at a fixed-rate to the offshore bank. Can the fixed-rate IRS payment to the offshore bank be considered to be a “payment in connection with” the loan taken up by the Singapore company from the Singapore-based bank, since the IRS payment was made to hedge exposure on the loan? If not, can the IRS payment be considered “a payment in connection with any arrangement relating to any loan or indebtedness”, being a payment in connection with an arrangement set up to hedge interest rate exposure on a loan? Hopefully more light will be shed on these points at the substantive hearing.

Putting aside the choice of prepositions for section 12(6)(a) and looking back at the mechanics of IRS, one question that the IRAS may be concerned with is whether IRS transactions truly never result in an element of loan or indebtedness between the parties to the transaction. Usually, this would be the case. However, it is possible to structure a swap such that there is a substantial lag in the timing of exchanges of cash flow. For example, a swap agreement can be set up whereby the non-resident party makes an upfront payment to the resident party, and the resident makes a series of payments over a period of several years to the non-resident. The periodic swap payments would presumably be computed such that they include an element of interest. Although taking the form of a swap, the transaction may be in substance a loan by the non-resident party to the resident party. In such a scenario, the transaction should fall within the scope of section 12(6) and withholding tax may apply, although the position is not entirely clear. This is unlike the case of ACC v CIT, where there is no lag in the timing of the exchange of cash flows, which is the case in most typical IRS transactions.

It will be interesting to see how the analysis will finally pan out in the full hearing for the quashing order application. Depending on the aspects that will be considered, the outcome of the full hearing may also have an impact on the withholding tax treatment of payments on derivatives other than IRS.

Please call your usual PricewaterhouseCoopers contacts if you have any questions on the withholding tax treatment of payments on IRS or other derivatives transactions.

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