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LEGISLATION COMMENTS AND LIST

TAX TREATMENT OF INVESTMENT COMPANIES:

INCOME TAX (APPROVED INVESTMENT COMPANIES) REGULATIONS 1990

IN the absence of a capital gains tax in Singapore, the distinction between "income" and capital" is crucial. A capital receipt cannot in the absence of a statutory provision be taxed as "income" and would be tax free. On a general level, the distinction has been often illustrated by the "tree and fruit analogy" cited by Sankey J. in *Pool* v. *Guardian Investment Trust Co. Ltd.*[1] So where an individual receives dividends from the shares in a company, the shares are the tree which produces the fruits of dividends; the shares are his capital and the dividends are his income subject to income tax. The disposition of his shares are not *prima facie* subject to income tax. However, the picture becdmes complex where the shares are so frequently transacted as to amount to "trading" and the receipts from the sale of shares to amount to "income". Under section 10(l)(a) of the Singapore Income Tax Act,[2] income tax is charged on the gains or profits of any trade, business, profession or vocation. Modern case law recognises that a transaction inVolving the purchase and sale of shares on a stock exchange may amount to (a) trading; (b) investment; or (c) "gambling".[3] The well-known passage of Clerk LJ. in *Californian Copper Syndicate* v. *Harris** is noteworthy:

> It is quite a well settled principle ... that where the owner of an ordinary investment chooses to realise it, and obtains a greater price for it than he originally acquired it at, the enhanced price is not a [trading profit]. But it is equally well established that enhanced values obtained from realisation or conversion of securities may be

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1 8 T.C. 167.

2 Cap. 134, 1985 Rev. Ed.

3 Barry Pinson, *Revenue Law* (17th ed., 1986), para. 2-06A. Pinson offers the interesting view on the legal basis for the U.K. Revenue Department's practice of not treating ordinary stock exchange transactions as trading transactions. He considers that they fall within the Department's category of "gambling transactions".

4 5 T.C. 159 at 165.

> so assessable, where what is done is not merely a realisation or change of investment but an act done in what is truly the carrying on, or carrying out, of a business. The simplest case is that of a person or associated persons buying and selling lands or securities speculatively, in order to make gain, dealing in such investments as a business, and thereby seeking to make profits.

The above summarises in a nutshell the difficulties of taxing investment companies. Dr. Richard Hu, the Minister for Finance, revealed in the 1988 Annual Budget Statement[5] that when the Government started looking into the promotion of the investment management industry, one factor cited by the private sector as an obstacle to the development of the industry was the issue of whether profits from securities transactions should be treated as trading income or capital gains. The Minister said that this matter was effectively resolved for non-resident investors by the Tax Exemption Scheme For Fund Management introduced in 1983.[6] The scheme relieved them of any Singapore tax liability on specified income derived from designated investments acquired by approved Singapore fund managers.

To resolve the issue of whether the gains derived by investment companies and unit trusts would be subject to tax, the Minister announced the introduction of a scheme whereby such companies and unit trusts could elect to have their profits from stocks or shares or other marketable securities taxed according to a schedule appendiced to the Budget Statement. The tax treatment would be based on the length of time for which the shares or marketable securities have been held. The appendix has been reproduced as the Schedule to the Income Tax (Approved Investment Companies) Regulations 1990[7] which has been reproduced as an appendix to this paper. To illustrate by example, a security may be held for 10 months and then sold. In this case, 80% of the gains from the sale would be subject to tax with an effective corporate tax rate of 26.40% based on the corporate tax rate of 33% applicable in 1988. Gains from the sale of another security which may have been held for more than 18 months would be subject to no tax. The principle discernible from the appendix is that the longer the security is held before it is disposed of, the lower the proportion of gains subject to tax. Presumably, the Minister in so doing was recognising the general principle that where the length of period of ownership is short, the gains realised are more

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5 Hansard, Vol. 50, col. 635; 4 March 1988.

6 This scheme was given legislative effect by the Income Tax (Income from Funds Managed for Foreign Investors) Regulations 1988 made pursuant to section 13C of the Income Tax Act which exempts income of a non-resident arising from funds managed by an Asian Currency Unit (ACU) or other approved fund manager.

7 G.N. No. S330/90.

likely to be a trading profit.[8] It was also announced that this alternative method of taxation would be effective from Year of Assessment 1988 and the Minister expressed the hope that it would lead to a more vibrant domestic fund management industry.

This statement was soon translated into law in the Income Tax (Amendment) Act 1989[9] which was passed on 26 January 1989. The Act introduced a new section 10A to the Income Tax Act with effect from the year of assessment 1988 which enabled the Finance Minister to provide by way of regulations for " the disposal of securities by an approved investment company to be levied and paid for each year of assessment upon such amount as may be determined by the reference to the period during which those securities have been held." A minor amendment to section 10A was made by the 1990 Income Tax (Amendment) Act[10] to exclude "unit trusts" from the definition of "investment companies" and to include units in a unit trust in the definition of "securities". Following representations from managers and trustees of unit trusts on modifications to the scheme in view of the special structure and operation of unit trusts, the Ministry of Finance announced in a press release dated 7 August 1989, that unit trusts would be taxed on a different basis.[11]

A new section 13D was also introduced by the 1989 Amendment Act to provide for the tax exemption of dividends declared out of that portion of the income derived by an investment company from the disposal of securities exempt from tax under section 10A. This is known commonly in tax parlance as a "follow-through" provision, *i.e.* the dividends declared out of the tax exempt gains credited to a special account will be exempt from tax in the hands of the shareholder. Without this provision, although the company will enjoy the tax concession, the shareholders will not benefit. The 1989 Act also made a related amendment to section 14F of the Income Tax Act (which relates to deductions for management expenses of investment companies) to exclude approved investment companies from qualifying for such deductions. This is apparently to prevent investment companies from enjoying concessions under both sections 10A and 14F of the Act.

On 31 August 1990, the legislative implementation of the scheme was completed with the eagerly awaited publication of the Income Tax (Approved Investment Companies) Regulations 1990[12] with retrospective effect from the Year of Assessment 1988.

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8 See *Wisdom v. Chamberlain 45* T.C. 92 where the taxpayer, an actor, purchased a quantity of silver ingots as a hedge against an anticipated devaluation. The silver was sold at a profit within little more than a year and the profit was held to be a trading profit.

9 Act 3 of 1989.

10 Act 23 of 1990.

11 See section 10B of the Income Tax Act (Cap. 134, 1985 Rev. Ed.). In a nutshell, only a prescribed percentage (10% as announced in the Press Release) of the gains of a unit trust will be taxed. No regulations have yet been made under section 10B.

12 See *supra,* note 7.

Scope of Scheme

The scope of the scheme can be ascertained by considering the definitions of "approved investment companies" and "securities". Section 10A applies to investment companies which are approved by the Minister or such other person as he may appoint. The writer understands that the Minister has appointed the Inland Revenue Department for this purpose. An investment company is defined as "any company whose business consists wholly or mainly in the making of investments and the principal part of whose income is derived therefrom". The first point to note is that the investment company must be "approved" and application has to be made for approval. It follows that investment companies may elect to be included in the scheme. It is thus not mandatory although the alternative would be that the companies' tax exposure would not have such great certainty as their gains would then be assessed as trading profits in the normal way in the light of the case law discussed above. The second point is that investment must not be merely a subsidiary or incidental activity of the company. Thirdly, the tax treatment is not available to individuals but only to companies. If one compares this definition with the other definition in section 14F, one will find that it is identical save for the omission of the words "and includes any unit trust" which were deleted in 1990.

The definition of "securities" is also important in the determination of the scope of section 10A as it applies only to "gains or profits derived from the disposal of securities". It may sound trite but it follows that it would not apply to gains or profits derived from instruments which do not fall within the definition of securities. For example, without the 1990 amendment it would not have covered gains derived from the disposal of units in a unit trust. These gains would then presumably be assessed in the usual way as trading income. "Securities" are defined as:

(a) debentures, stocks, shares, bonds or notes issued by a government or company;
(b) any right or option in respect of any such debentures, stocks, shares, bonds or notes; or
(c) units in a unit trust.

The definition is wide and would cover the full range of securities quoted on the Stock Exchange of Singapore including options, warrants, bonus shares, rights issues, rights entitlements or share splits. It would also be sufficiently wide to cover securities listed on SESDAQ.[13] It is interesting to note that the definition is not confined to securities listed on the

[13] Singapore Stock Exchange Dealers' Automated Quotation.

Stock Exchange in Singapore. It could cover US NASDAQ[14] shares quoted on the Stock Exchange and shares of Malaysian counters quoted on the Exchange under CLOB[15] International. However, where foreign securities are traded outside Singapore, the overriding principle is that the gains would not be taxable as they are not derived in Singapore unless they are "received in Singapore" within the meaning of section 10(1) of the Act. Warrants and rights would also be covered as they are "rights or options in respect of stocks or shares". Government bonds are also included.

Determination of Taxable Gains

The Income Tax (Approved Investment Companies) Regulations 1990[16] provides that the amount of any gains or profits derived from the disposal of securities and chargeable to tax will be determined by reference to the percentage in the 2nd column of the Schedule which is applicable to the period the securities are held (regulation 2(2)). The Schedule is in substance the appendix of the Budget Statement. The Schedule is reproduced in the Appendix to this paper.

For example, 1,000 shares in *ABC* Ltd are purchased by *XYZ* investment company for $2,000 on 1 August 1990 at the price of $2 per share. Following the rise of the Stock Exchange during the Gulf War, the shares are subsequently sold on 1 March 1991 for $3,000 at the price of $3 per share. The shares would have been held for 212 days. Under the Schedule, the 2nd column specifies that the percentage of gains chargeable to tax is 90% and in the 3rd column it is specified that the remaining percentage of 10% is not chargeable to tax. The gains would then be determined by the sale proceeds of $3,000 less the cost of $2,000 which is $1,000. Out of this amount of $1,000, $900 would be chargeable to tax and $100 would not be chargeable. The apportioned expenses such as broker's commissions, capital allowances and deductions are then deducted from the $900. The balance of say $800 would then be taxed at the corporate tax rate of 31%. The tax would then be 31% X $800 = $248. The whole transaction can be set out as follows:

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[14] National Association of Securities Dealers' Automated Quotation.
[15] Central Limited Order Book.
[16] See *supra*, note 7.

EXAMPLE

Proceeds from sale of 1,000 *ABC* shares at $3 per share	$3,000	
Less cost of 1,000 *ABC* shares at $2 per share	$2,000	
Gains from disposal	$1,000	
Proportion chargeable to tax based on 212 days holding period		90% X
Amount chargeable to tax	$ 900	
Less expenses, capital allowances, deductions and donations	$ 100	
Net Amount chargeable to tax	$ 800	
Corporate tax at 31%		31% X
Tax	$ 248	

Meanwhile the $100 being the portion not chargeable to tax would have been credited into a special account pursuant to section 13D less the expenses, allowances and deductions. Tax exempt dividends may be paid out of this account. As losses are deductible against profits in determining income, regulation 2(3) also determines the amount of loss which can be deductible against gains or profits by reference to the holding period. Hence if the shares were held for 212 days and sold at a loss, only 90% of the amount of loss can be deductible against gains or profits which are chargeable to tax. The remaining 10% must be deducted against gains or profits not chargeable to tax. In practical terms, it reduces the amount that can be credited into the special account for declaration of tax exempt dividends. The manner and extent to which any expenses, capital allowances, losses and donations are to be deducted will under regulation 2(4) be determined by the Comptroller of Income Tax. Where the amount of any expenses, capital allowances, losses or donations exceeds the gains or profits not chargeable to tax, the excess cannot be deducted against any other income (regulation 2(5)).

Bonus Shares, Shares Splits, Rights Issues and Options (Warrants)

The example given above is fairly simplistic but anyone who has experienced trading on the Stock Exchange will know that it is not reflective of the real market situation where many variations serve to complicate transactions. As an illustration, let us say in the example given above, *ABC* Ltd. had issued bonus shares in the ratio of 1 bonus share for every share held on 2 January 1991. Subsequently on 1 February 1991, in order to raise capital, *ABC* Ltd. offers a rights issue coupled with a warrant of one share at $1.50 and one warrant for every share held including the bonus shares. A warrant is basically an option to purchase shares at a certain pre-determined price on any date before the specified future date. *XYZ* investment company decides not to take up the rights issue but to sell its rights entitlements for $1,000 at $0.50c each. On 1 March 1991, the investment company holds 1,000 of the original lot of shares and 1,000 bonus shares. The total of 2,000 *ABC* Ltd. shares are sold at $3 per share for $6,000. A few difficulties are immediately apparent. Firstly, what is the holding period in respect of the bonus snares? Secondly, what is the cost of the bonus shares and the rights entitlements which were acquired without payment? There is little difficulty if all the 2,000 shares and the rights entitlements are sold together. The gain could simply be calculated as $7,000 less $2,000, *i.e.* $5,000. But if the shares and warrants are sold piecemeal over different periods and invariably at different prices, difficulties would arise. The regulations have attempted to deal with these variations through a form of "interpretation" provision in regulation 3 which consists of paragraphs (a) to (1). The writer realises that the regulations cannot exhaustively cover the many permutations and innovations practised in the stock exchange but only the more common devices.

The approach adopted by regulation 3(c) in determining the length of the holding period of bonus shares and shares arising from a share split is to deem them to have been acquired on the date of purchase of the original shares upon which the bonus shares or split shares are based. Similarly, in determining the average unit cost of bonus shares and shares arising from a share split, the cost of the original shares is divided by the total number of split shares or in the case of the bonus issue, the total number of the original and bonus shares. In the example above, the bonus shares would be deemed to have been acquired on 1 August 1990 and held for 212 days. The cost would, however, have to be first reduced by the proceeds of $1,000 from the sale of the rights entitlements (regulation 3(d)). The average unit cost of each share would thus be $1,000 divided by 2,000 shares, *i.e.* $0.50c per share. Since the shares were sold at $3 per share on 1 March 1991, the gain would be an average of $3 - $0.50c = $2.50c per share. Since they were deemed to be held for 212 days, 90% would be chargeable to tax, *i.e.* $2.50 X 90% = $2.25. If one lot were sold for $3 and another lot for $4, the gains could be calculated by reference to the average unit cost of $0.50c per share.

Exchange of Shares in Take-Over or Reconstruction

When shares are exchanged for shares or partly for shares and partly for cash, is that a realisation chargeable to tax? There is authority to suggest that it is. In *Westminster Bank* v. *Osier (HM Inspector ofTaxes);*[11]

[17] [1933] A.C. 139.

the House of Lords held that the conversion of National War Bonds by the appellant Bank into *5%* War Loan and 3'/2% Conversion Loan, the value of the stocks received in exchange being greater than the cost to the Bank of the National War Bonds converted, was equivalent to the realisation of investments and the increase in value was chargeable with income tax upon that sum under Schedule D Case I of the U.K. Income Tax Act 1918[18] as upon a taxable profit. The House of Lords also approved in that case *Royal Insurance Co.* v. *Stephen*[19] where a railway company was required under the Railways Act of 1921[20] to accept new stocks in the amalgamated companies in exchange for the stock held in the companies which were absorbed. The company in its tax returns claimed that it was entitled to deduct the loss which had arisen from the exchange. Rowlatt J. upheld the claim and consequently the Finance Act of 1931[21] expressly provided that *Stephen's* case should not apply to any future exchanges which were then contemplated.

With regard to the U.K. statutory position, where shares held as circulating capital *(e.g.* trading stock) are exchanged for other shares or securities, *e.g.* on a takeover, the shares acquired on the exchange have to be valued and any profit on the transaction is taxable under Case I of Schedule D of the U.K. Income Tax Act.[22] Regulation 3(f)[23] appears to adopt the principle that an exchange would amount to realisation of investments. It provides that where shares are exchanged for any other shares, the first-mentioned shares shall be deemed to have been disposed of on the date of acceptance by the approved investment company of the offer to exchange the shares. However, this rule does not apply to the exchange of shares in the circumstances of a compulsory acquisition of shares in a takeover or reconstruction. It would by now be obvious that the date of disposal is of crucial importance as it determines the holding period which in turn determines the proportion of gains, if any, which are chargeable to tax. It is noteworthy that the date of disposal is pegged to the date of acceptance of the offer and not the date of the actual exchange. This is consistent with the practice in the Stock Exchange where the contract date matters more than the actual transfer of title to the shares. In "scripless trading" the shares are registered in the name of the Central Depository Private Limited.

Regulation 3(g) provides for the date of disposal and the cost of shares in the compulsory acquisition of shares in a takeover and reconstruction. It envisages two forms of exchange of shares. Firstly, an exchange wholly for shares and secondly, an exchange partly for shares and partly

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[18] 8 & 9 Oeo. 5.
[19] 14T.C. 22.
[20] 11 & 12Geo. 5.
[21] 21 & 22 Geo. 5.
[22] See *supra,* note 3, paras. 2-13A.
[23] See *supra,* note 7.

for cash. Generally, a person who succeeds in a takeover bid has no power to force minority shareholders to sell out their holdings to him. However, although regulation 3(g) does not specifically refer to section 215 of the Companies Act,[24] where a company acquires 90% of its shares of another company in a takeover or reconstruction, it has power pursuant to section 215 to compulsorily acquire the shares of minority shareholders. Regulation 3(g) would apply to an investment company which is the minority shareholder. Regulation 3(g)(iii) provides that the acquired shares shall be deemed not to have been disposed of and the new shares exchanged for the acquired shares shall be deemed to have been acquired on the date of purchase of the acquired shares. This is a significant concession as the regulation presumes that there is no realisation in a compulsory acquisition unlike in other situations which would fall within regulation 3(f).[25] The case of *Royal Insurance Co.* v. *Stephen*[26] suggests that there is a realisation even where shares are compulsorily exchanged by statute. It is provided in regulation 3(g) that if the acquisition is wholly for shares, the cost of the new shares exchanged as consideration for the acquired shares shall be deemed to be the cost of the acquired shares. For example, *A* Ltd. takes over *B* Ltd. and compulsorily acquires *B* Ltd., shares held by *XYZ* investment company which is the minority shareholder. *A* Ltd. gives *XYZ* one *A* Ltd. share for every 4 *B* Ltd. shares surrendered. *XYZ* had acquired the *B* Ltd. shares for $1 per share. *XYZ* would be deemed to have acquired the *A* Ltd. shares on the date of purchase of the *B* Ltd. shares and the cost of the *A* Ltd. shares would be deemed to be $4, *i.e.* the cost of 4 B Ltd. shares. In other words, the new shares are treated as substituted for the acquired shares and "stepped into the shoes of the acquired shares". If money is involved in the exchange, regulation 3(g)(ii) provides that the same formulation would apply except that the cost of the acquired shares would be reduced by the payment in money. Taking the same example, where *A* Ltd. acquires 4 *B* Ltd. shares for one *A* Ltd. share and $1, the cost of the *A* Ltd. shares will be deemed to be $4 being the cost of *B* Ltd. shares less $1 being the payment in cash, *i.e.* $3 per share. If the amount paid in money exceeds the cost of the acquired shares, the excess shall be chargeable or not chargeable to tax by reference to the Schedule applicable to the holding period of the acquired shares. Hence if in our example, the offer were one *A* Ltd. share plus $5 for every 4 *B* Ltd. share, there would be an excess of $1 over the cost of $4 for the 4 *B* Ltd. shares. The excess of $1 will then be chargeable or not chargeable to tax by reference to the percentages specified in the Schedule applicable to the holding period of the acquired shares.

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[24] Cap 50, 1985 Rev. Ed.

[25] See discussion above.

[26] See *supra*, note 19.

Gains or Profits Derived from Outside Singapore

As mentioned above, gains or profits derived from outside Singapore are not subject to tax unless they are received in Singapore. Regulation 3(j)[27] provides for the "first-in, first-out" rule whereby gains or profits derived outside Singapore from the disposal of securities and remitted into Singapore will be determined on the basis that gains or profits derived earlier are remitted before those which are derived later. Presumably, the rationale for this provision is to avoid difficulties in tracing the gains or profits remitted from the disposal of a number of different securities outside Singapore. It would also prevent an investment company from arguing that since only a proportion of gains or profits are chargeable to tax in accordance with the Schedule, the company would only remit that portion which is not chargeable to tax and not remit the chargeable portion. In other words, investment companies cannot" pick and choose" which part of their gains or profits to remit into Singapore. Regulation 3(i) prevents expenses, capital allowances, losses and donations attributable to gains or profits derived from disposal of securities outside Singapore, from being deducted against local income *(i.e.* income other than such gains or profits).

Conclusion

The Regulations have attempted to deal with the majority of variations in transactions on the Stock Exchange. They do not do so exhaustively but the writer believes that they are workable Regulations and expects them to be fine-tuned by amendments in the future.

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[27] See *supra,* note 7.

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APPENDIX

THE SCHEDULE

First column	Second column	Third column	Fourth column	Fifth column
Length of period securities held	Percentage of gains or profits chargeable to tax	Percentage of gains or profits not chargeable to tax	Percentage of loss deductible against gains or profits chargeable to tax	Percentage of loss deductible only against gains or profits not chargeable to tax
Not exceeding 180 days	100	0	100	0
181 days to 210 days	95	5	95	5
211 days to 240 days	90	10	90	10
241 days to 270 days	85	15	85	15
271 days to 300 days	80	20	80	20
301 days to 330 days	75	25	75	25
331 days to 360 days	70	30	70	30
361 days to 390 days	60	40	60	40
391 days to 420 days	50	50	50	50
421 days to 450 days	40	60	40	60
451 days to 480 days	30	70	30	70
481 days to 510 days	20	80	20	80
511 days to 540 days	10	90	10	90
Exceeding 540 days	0	100	0	100