FOURTH SESSION

2 September 1977 (afternoon session)

TAXATION

Chairman: Andrew Ang

James Chia, "Tax Implications and the Asian Dollar Market"

Brij Soin, "Income Tax Strategies in the Singapore Asiandollar Market"

Loke Kit Choy, "U.S. Tax Problems Connected with Investments in Singapore"

Commentator: S. Khattar

Discussion

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Chairman: I shall call on Mr. James Chia to deliver his paper.

TAX IMPLICATIONS AND THE ASIAN DOLLAR MARKET

by

JAMES CHIA

INTRODUCTION

Since its inception in October 1968, the Asian dollar market has made a major impact on the financial scene in Asia and in particular Singapore. The market in Singapore is geared essentially to servicing external markets, the purpose being to pool US dollars and other convertible currency holdings and to channel these funds into productive investment in Asia. While previously funds had been extracted from Asian countries to the Eurodollar market, the situation has been reversed, with net funds from Europe and the United States being mobilised for use in Asia. The major borrowers have been multinational corporations, governments and local companies embarking on projects to enlarge and modernize their operations.

GROWTH OF ASIAN DOLLAR MARKET

Measured in terms of total assets/liabilities of the 74 Asian Currency Units (ACU) in operation, the gross size of the Asian dollar market in Singapore was US$18.8 billion at the end of June 1977. The rate of growth in 1976 was 38 per cent compared with 22 per cent in 1975. However, the average annual growth rate was 32 per cent, as against 35 per cent for 1975. The net size of the market, approximated by excluding inter-ACU redepositing, was US$14.4 billion at the end of 1976. This is equivalent to about 6 per cent of the estimated net size of the Euro-currency market.

In 1976, loans to non-bank customers expanded as a whole by US$846 million, compared with US$674 million in 1975 though the amount was only half that in 1974. In contrast, bonds raised in the Asian dollar bond market amounted to US$266 million as against US$47 million in 1975. The increase in ACU loans to non-bank customers in 1976 was largely channelled to Asian governments, the manufacturing and transport, storage and communication industries and financial institutions. At the end of December 1976, the proportion of loans to the manufacturing sector remained at 28 per cent. The share of non-bank financial institutions was however reduced to 26 per cent from 29 per cent at the end of 1975. Significant amounts were also extended to foreign governments, the general commerce and the transport, storage and communication sectors.

About 90 per cent of the funds in the market are US dollars, the remainder being mainly Deutsche marks, Swiss francs, French francs, Japanese yen and sterling. The market daily volume is estimated to be US$150-200 million. Similar to the Euro currency market, the Asian dollar market is predominantly of an interbank nature including transfers of bank credits from Europe to Singapore. Hence, ACU claims on banks including other ACUs as at the end of 1974, comprised 73 per cent of the total assets, and liabilities *vis-a-vis* banks and other ACUs accounted for 82 per cent of the total liabilities.

ACUs: resources and borrowers

The ACUs draw their resources from 4 main categories of lenders:

(i) central banks — known to hold large quantities of hard currencies in reserves;

(ii) commercial corporations — usually a source of short term money awaiting disposal;

(iii) individuals — numerous affluent individuals seeking a more stable home for their cash than the situations in their countries permit;

(iv) commercial banks outside Singapore — including those in the Eurodollar market which will by choice deposit in the most secure country and funds are brought in from Europe in view of Singapore's low political risk.

The borrowers in the market are as diverse in nature and may include:

(i) multinational corporations with a parent company willing to guarantee such loans;

(ii) export-oriented companies located in countries where permission is given for the retention of enough foreign currency to meet loan repayments or where approval is specifically given to purchase currency for such requirements;

(iii) companies located in countries where free convertibility and movement of funds is permitted;

(iv) commercial banks;

(v) government and government sponsored institutions.

In 1972 and 1973 a higher level of non-bank deposits and loans was noted whereby residents were allowed to participate in the Asian

dollar market. This is due to the liberalization of exchange control restrictions, in particular:

(i) permitting ACUs to make specified currency loans to local companies to finance credit outstanding from time to time on goods exported from Singapore;

(ii) allowing Singapore insurance companies and certain provident funds to invest up to a specified limit of their funds in the market;

and in July 1973,

(iii) permitting individuals and corporations for the first time to invest in specified currencies in ACUs up to the following limits:

(a) individuals up to S$100,000 (US$40,000) at any one time;

(b) Singapore companies (other than unit trusts or mutual funds) up to S$3 million (US$1.2 million) at any one time;

(c) approved unit trusts, mutual funds and investment trusts up to S$5 million (US$2 million) or 15 per cent of their funds.

In addition, Singapore companies have also been permitted to retain specified currency receipts up to S$3 million (US$1.2 million) at any one time. These may be used to meet their committed liabilities to non-residents of Singapore.

Liberalization of exchange controls and tax legislation

The development of the Asian dollar market was given another boost in early 1976, following further liberalization of exchange controls and the announcement of new fiscal incentives. In February 1976, among the exchange control regulations liberalized was the increase in the limits for resident investments abroad including the Asian dollar market. Greater participation by residents in the Asian dollar market was permitted with the raising of the ceiling on investment in the market from S$3 million to S$5 million for resident companies and from S$100,000 to SS250.000 for resident individuals. In January 1977 this was increased to S$500,000, Limits for approved unit trusts, mutual funds, investment trusts remained unchanged at S$5 million.

In line with the revision of exchange control regulations, the terms and conditions under which ACUs may operate were also revised to ensure consistency. Thus, ACUs have been permitted to transact in all currencies other than in Singapore dollars, when dealing with non-residents of Singapore whereas previously, they could only deal in Specified Currencies or in Scheduled Territory Currencies from External Accounts.

Looking at tax legislation, since 1968 interests derived from deposits by non-residents in approved banks in Singapore are exempt from income tax. However, the non-resident institution must not carry on a business in Singapore or have a permanent establishment in Singapore. In 1973 offshore income of financial institutions derived from the operation of its Asian Currency Unit was granted concessionary rate of 10 per cent. Further tax concessions announced in March 1976 provided incentives for participation in the Asian dollar

market. Under the new concessions, commissions and fees earned from the confirming and negotiation of offshore letters of credit would be taxed at the rate of only 10 per cent instead of 40 per cent, while Asian dollar bonds purchased by non-residents as well as their deposits with ACUs, would be exempt from estate duty. Stamp duty, as well as non-resident interest earnings on Asian dollar bonds, has also since August 1973 been tax exempt.

To further strengthen the framework for development and growth in the Asian dollar market, the Government decided to streamline the tax on income of ACUs. In February 1977 it was announced that the 10 per cent concessionary tax would be extended to cover all offshore income of ACUs other than exchange profits and income from transactions with domestic banking units and residents. The tax concession is also extended to cover income derived from transactions amongst ACUs and with banks outside Singapore, dealings in negotiable certificates of deposits, foreign currency bankers' acceptances and Asian dollar bonds. The concession will take effect from the year of assessment 1978 to cover earnings in 1977.

Presently, income derived by ACUs from the following transactions are treated as "offshore income" and taxed at a concessionary rate of 10 per cent:

(i) loans granted to offshore non-resident borrowers;

(ii) fees received from advising, conforming and financing or re-financing of letters of credit of offshore third country trade transactions with or without offshore letters of credit;

(iii) income from interbank transactions with other ACUs and banks outside Singapore—this includes:

  (a) placement of funds;

  (b) bankers' acceptances on offshore bills;

  (c) transactions in offshore bills;

  (d) transactions in foreign currencies Negotiable Certificate of Deposits;

(iv) income derived from management, floatation, underwriting, brokering, dealing, investments and other transactions in Asian Dollar Bond;

(v) income from brokering, dealing, transacting and investments in Eurodollar bonds and other bonds and investments denominated in foreign currencies dealt with by ACUs.

However, income derived from the following transactions are taxed at 40 per cent:

(i) interbank transactions with domestic banking units in Singapore;

(ii) loans to Singapore non-bank residents;

(iii) foreign exchange transactions.

Comparison with financial centres in the region

A look at our neighbours, the Philippines and Hongkong, regarding their tax legislation in their promotion of their countries as financial

centres would be beneficial. The Philippines have established an offshore banking system that is competitive with offshore banking centres in the region.

In a Presidential Decree No. 103A made on September 30, 1976, it was enacted that:

> "(a) the transactions of offshore banking units authorised hereunder with non-residents and other offshore banking units shall be subject to a five per cent (5%) tax on the net income from such transactions which shall be in lieu of all taxes on the said transactions: Provided, however, that transactions of offshore banking units with local commercial banks, including branches of foreign banks that be authorised by the central bank to transact business with offshore banking units, shall likewise be subject to the same tax, except net income from such transactions as may be specified by the Secretary of Finance, upon recommendation of the Monetary Board, be subject to the usual income tax payable by banks. Any income of non-residents from transactions except offshore banking units shall be exempt from any tax.
>
> (b) In the case of transaction with residents (other than other offshore banking units of local commercial banks including local branches of foreign banks that may be authorised by the central bank of the Philippines to transact business with offshore banking units), interest income from loans granted to such residents shall be subject only to a ten per cent (10%) withholding tax as final tax."

Hong Kong has an edge over Singapore in that there is no tax on offshore income. There is no withholding tax on interest paid on offshore interbank transactions. The 15 per cent tax on interest is only applicable to domestic transactions. In addition foreign banks may operate branches in Hong Kong as branch offices without their being licensed as banks. This certainly has stimulated the development of a bigger interbank market. Financial companies are also permitted to operate ACUs. Leading American banks are sited in Hong Kong for this particular tax reason because they are running out of their tax credits back home and are looking for low or nil tax areas to minimise their tax on their overall worldwide earnings. In this respect, leading American banks do not book their offshore loans in Singapore but in Hong Kong. Thus Hong Kong is known as the "booking" centre and Singapore as the "funding" centre because there is no tax on interest on deposits by non-residents. Reference to this point in relation to a tax strategy will be referred to later. While no withholding tax applies to interbank transactions, the Hong Kong Revenue Authorities have recently extended such exemption to interest paid by banks to banks (and subsidiaries of banks) outside Hong Kong. Thus there is no withholding tax disadvantage in relation to Singapore for funds from other banks. This edge will in the near future put Hong Kong in a more favourable position when its financial market is more developed to include a funding centre as well.

Some tax strategies

A consideration of three tax strategies will show the extent to which bankers in Singapore may plan their transactions to circumvent the tax provisions,

Illustration 1

Taking advantage of the 10 per cent tax rate, banks would manipulate their transactions to qualify for the concession. A Singapore

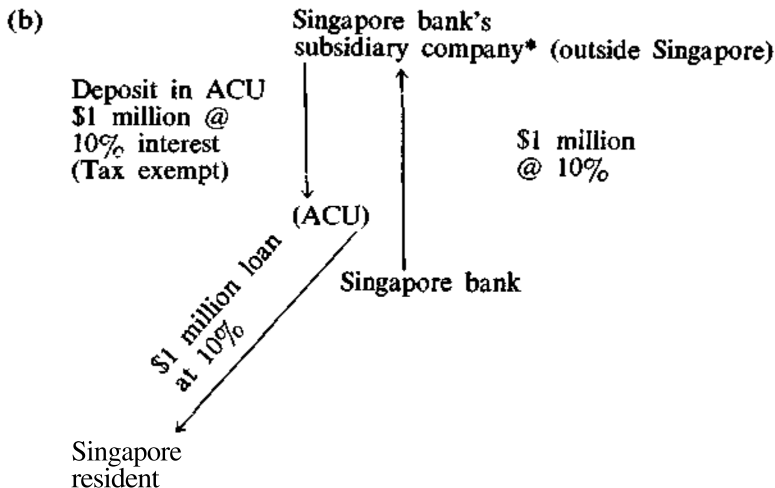
bank could advise their client to set up a joint venture or a subsidiary in Indonesia. The Singapore bank would make a straight term loan to the Indonesian company and thereby qualify for the 10 per cent on the income from the loan. The Indonesian company would thus make use of the loan to invest or trade in whatever they desire.

A more ingenious scheme would be for the ACU of a bank which intends to give a loan of $1 million to a Singapore resident company at 10 per cent, to arrange to give the loan to an offshore company at 10 per cent and such offshore company would in turn deposit the sum back with the bank's ACU at 10 per cent. The bank's ACU would then lend the Singapore resident at 10 per cent. Assuming the cost of funds to the bank is 8 per cent, the bank would have a net offshore income of 2 per cent on $1 million which is subject to concessionary 10 per cent tax. The loan to the Singapore resident company at 10 per cent will not generate any income tax as such funds were brought back at the same rate from the offshore company at 10 per cent.

The diagram below illustrates the normal direct loan by a Singapore bank to a resident and one under the ACU.

A Singapore bank gives $1 million loan to a Singapore resident. This can be done in two ways. The fund is from deposits with Asian Currency Unit of the bank which pays interest at 6 per cent:

(a)	Singapore bank —	Interest @ 6%	$60,000		
	↓ $1 million loan	Other expenses @ 2%	20,000	Cost	$ 80,000
	Singapore resident pays interest at 10%				100,000
	Gains to the bank				$ 20,000
	Tax at 40%				$ 8,000

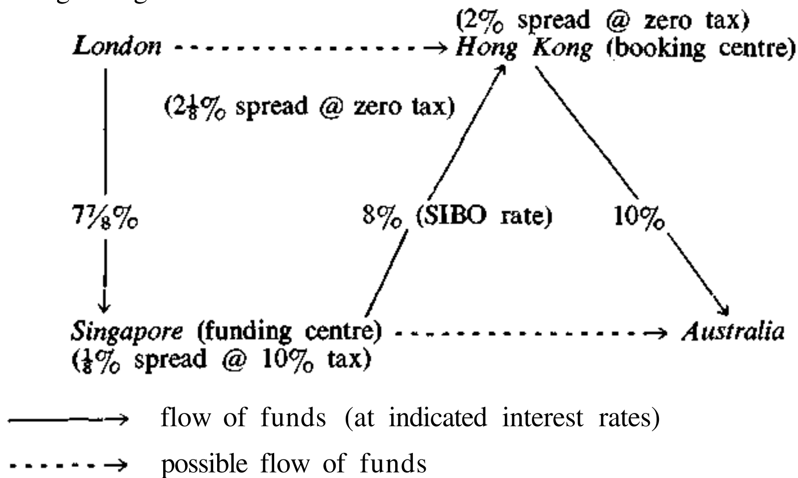


* This can be a nominee company, agent, joint venture company etc.

Cost (interest) and other expenses	$ 80,000	same as (a)
Interest received from the subsidiary	100,000	
Gains to the bank	$ 20,000	
Tax at 10% under Section 43A	$ 2,000	
Tax saving	$ 6,000	

Illustration 2

The advantage of Hong Kong as a "booking" centre is shown in the diagram wherein the credit spread averaging 2 per cent is not subject to any tax. Singapore is maintained as a funding centre for such loans booked in Hong Kong and the trading spread (averaging $\frac{1}{8}$%) is kept in Singapore where it is taxed at 10 per cent. The illustration shows an American bank in Singapore borrowing from London to lend to a non-bank borrower in Australia after booking the loan in Hong Kong.



———→ flow of funds (at indicated interest rates)

- - - - - - → possible flow of funds

Singapore's role as a funding centre is apparently associated with the lower sovereign-risk here, trading skills and expertise available here and the slight time-zone advantage we have over Hong Kong with regard to trading with London. In addition, interbank transactions with banks outside Singapore have been granted the concessionary tax rate of 10 per cent. It is envisaged that when the financial infrastructure is more developed in the near future and Hong Kong reduces its tax on interest by non-resident depositors to zero, it may then displace Singapore as a funding centre.

Illustration 3

Loan agreements by banks arising from ACUs if executed in Singapore are subject to stamp duty of $\frac{1}{2}$ per cent of total amount of loan if it is the principal and primary security. A US$10 million loan would attract S$122,500 stamp duty. To avoid the payment of such

high stamp duties, the documents could either be executed in Johore Bahru or Hong Kong and retained there where a nominal stamp duty is charged. Alternatively, two documents could be executed simultaneously, i.e. an agreement made under hand only which attracts $1/- stamp duty and a promissory note made in favour of the bank which is exempted from duty.

However by a recent amendment to the Stamp Duty Act, loan agreements where it is the principal and primary security need not pay a stamp duty of ½ per cent of total amount of loan but a sum not exceeding $500/-.

SINGAPORE: A NEED TO BE COMPETITIVE

Comparing Singapore's offshore banking activities with those of Hong Kong and the Philippines we should constantly keep sight of our neighbours' tax laws on domestic and offshore income so as to be competitive with them. ACU transactions are transactions with non-residents or with the offshore market and includes transactions with non-residents and other ACUs. They are in fact separate book-keeping entities of banks dealing with offshore funds. Inter-ACU transactions are part of the international offshore market that enables an ACU to lend to another ACU fund it had borrowed from an offshore source. Likewise, it is an alternate source of funds to ACUs that are negotiating to finance offshore loans. The only leakages of these offshore funds to the domestic sector are through transactions with domestic banking units and loans to non-bank resident corporations and the income derived from these two domestic transactions are taxed at 40 per cent. Thus the tax rate applicable to inter-ACU placement of funds should be the same as the tax rate applicable to ACU transactions with banks and financial institutions outside Singapore as the former is the other arm of a financial centre's function of funding offshore funds. Prior to 1977, there was the existence of these two tax rate i.e. a 10 per cent for ACU interbank transactions with banks outside Singapore and a 40 per cent for transactions with ACUs resulting in the undesirable situation of a 2-tier quote rate which hindered inter-ACU activities within Singapore. However it is gratifying to note that our enlightened Monetary and Revenue Authorities have adopted a realistic approach to this problem by eliminating the 2-tier quote to a uniform 10 per cent rate with effect from January 1977.

I would not be doing justice to this seminar if I do not mention the significance of double taxation agreements in transnational enterprise investing in Singapore. There are enormous benefits and advantages to foreign corporations, multinationals and banks in their dealings in this region.

With regard to the question of tax relief for foreign withholding tax much has been discussed and criticised about our provisions. It is true that the imposition of a 40 per cent tax (on Company) on interest received by Singapore branches of foreign banks would bring the total tax incidence (e.g. 25 per cent Indonesian withholding tax plus 40 per cent Singapore tax on interest) above the 40 per cent tax burden. However two features ought to be looked at.

Firstly in relation to branches of foreign banks they are subject to Singapore tax on the profit. After allowing deductions for ex-

penses it can be seen that Singapore tax is actually levied on the net income.

As illustrated below:—

Interest from Indonesia			100
Indonesian withholding tax			25
Amount received in Singapore			75
Less:	Interest paid by banks (at 7%)	70	
	Other and Administrative expenses	3	73
	Subject to Singapore tax		2
	Singapore tax at 40%		0.8

Thus the total incidence of tax would be 25.8 per cent (i.e. 25 Indonesian tax and 0.8 Singapore tax). The above illustration is based on the assumption that banks borrow at 7% and lend at 10%.

Foreign banks operating in Singapore would be subject to tax in their home countries. With the United States corporation tax rate at 48 per cent, the United Kingdom at 52 per cent and the majority of developed countries about 40 per cent, foreign banks in Singapore do not suffer higher tax burdens back in their country of residence. It should be noted that whatever tax concession is given by Singapore it would only benefit home countries' treasuries except where there are tax sparing provisions in our double taxation agreements with them. In this respect many merchant banks with American participation are incorporated in Singapore whereby there is no need to repatriate profits to country of residence. In comparison with Hong Kong and its 17.5 per cent profits tax, American Banks would have an advantage locating its office in Hong Kong where they intend to utilise and exhaust their tax credits but would have no additional advantage by locating it in Singapore where the majority of their overseas operations are in countries with an equal or lower tax of 48 per cent.

An important feature of countries with double taxation agreements with Singapore is that where funds are deposited in Singapore the tax imposed by the country of source, i.e. Singapore is the final tax. Thus if a corporation from Thailand deposits sums of money in a Singapore bank, the interest tax of 10 per cent (in the case of financial institutions) and 25 per cent in all other cases is the final tax pursuant to the Singapore/Thailand Double Taxation Agreement. However if it is deposited in Hong Kong, there is a 15 per cent withholding tax on interest on the gross and a further corporation tax on the net in Thailand if it is brought back. This would certainly work to the disadvantage of the Thai corporation.

In relation to Singapore borrowers, resident banks are allowed to borrow from the ACU. Where the loans are used in Singapore the interest paid is deducted against the profits of the resident bank and the interest paid to the banks is subject to tax as part of the profits of the banks and the various expenses including interest paid

to non-residents in ACU accounts are allowed for deductions. Local companies are not subject to a 40 per cent withholding tax and the interest paid by them is allowed for deduction against the income. Section 45 of the Income Tax Act provides deduction for tax at 40 per cent from interest paid to non-residents only. Where the non-residents can show that a Singapore tax is less than what has been deducted, the excess of the tax collected (this is not withholding tax but is an advance collection which is set-off against the liability of the interest recipients) would be refunded. This happens where double taxation agreements for non-resident relief to the recipients of the contracting states concerned and the actual tax is less than the amount collected under Section 45. The purpose of a financial centre for the region is to garner offshore funds for the use of borrowers in the region. Hence, where Singapore corporations are borrowers of ACU funds no tax concession is given.

INCOME TAX AND STRATEGIES IN THE SINGAPORE ASIANDOLLAR MARKET

by

BRIJ S. SOIN

1. *INTRODUCTION*

Business regards all taxes — income tax, sales tax, import and export taxes etc. — as compulsory contributions to government funds; as costs of production which are similar to the trade costs of manufacture, distribution and selling. Where these tax costs can be included in the selling prices, with the result that the customers bear them and leave a margin of profit for the enterprise, the business will continue and develop. Otherwise its objectives and growth will frustrate.

The domestic taxes in a jurisdiction help to determine the level of prices in that country and transactions are possible at that level. Where the business is punished is where a double claim is made by two taxing authorities on the same income or transaction. This overlapping taxation must be eliminated if international business is to grow and prosper. The way in which overlapping taxation can be removed is simple. All that is needed is an international code. For example, a starting point in this region could be an Asean tax code which provides that each country should tax only that income which arises or the capital which is situated in or the transaction which is effected within its jurisdiction and abstain from taxing other income, capital or transaction.

2. *THE SINGAPORE TAX SCENE*

Income Tax was introduced in Singapore in 1948 in not too pleasant circumstances. The Singapore Income Tax Act does not contain anything particularly difficult or obscure as to who is taxable, on what and at which rate. When compared with taxation legislation of the United Kingdom, India or the United States our Act stands in the simple innocence of its infancy.