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Tax alert

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GIR v Comptroller of Income Tax – What is trading in derivatives under the FSI Regulations

Introduction

The recent Income Tax Board of Review case of *GIR v Comptroller of Income Tax* [2025] SGITBR2 is the first time there is a tax litigation in Singapore involving the Income Tax (Concessionary Rate of Tax for Financial Sector Incentive Companies) Regulations 2005 ("FSI Regulations") or its subsequent 2017 regulations.

The bone of contention is what falls under "trading in derivatives" of the FSI Regulations. The Income Tax Board of Review ("Board") held that the Appellant was not "trading in derivatives" and therefore did not fall under the FSI Regulations in respect of the specific set of transactions.

Background

- The Appellant entered into a series of transactions ("Transactions"), starting with a subscription to two classes of redeemable preference shares ("RPS") issued by STU ("Issuer") for a total of US$400m in May 2008.
- The subscription agreement provided for certain dividend amounts and RPS redemption amounts, calculated using certain agreed observation date, strike price and JPY/USD spot exchange rate.
- A set of put options were also entered into by the Appellant and Bank A, requiring Bank A to acquire the RPS at the same price as mentioned in the subscription agreement if the Issuer did not redeem the RPS by the end of December 2008.
- A dividend of US$99.8m was paid in December 2008 and the RPS was redeemed at a price of US$303.7m, resulting in a loss of US$96.3m on the RPS.
- The dividend income of US$99.8m was a tax-exempt dividend and the Appellant claimed tax deduction on the RPS loss of US$96.3m under the prevailing normal corporate tax rate of 18%.
- The Respondent (i.e. Comptroller of Income Tax) took the view that the deduction of the loss of US$96.3m should be against the 10% concessionary tax rate under the FSI Regulations on the basis that it falls under regulation 4(1)(j) – trading in derivatives.

The approach adopted by the Board

There is no dispute that the Appellant was a Financial Sector Incentive – standard tier company. The key dispute is whether the RPS redemption loss of US$96.3m should be deducted under the prevailing corporate tax rate of 18% or the concessionary tax rate of 10% per FSI Regulations.

To address this issue, the Board laid down three key questions:

1. Whether there is a derivative in the Transactions within the meaning of regulation 4(1)(j) of the FSI Regulations.

2. If the answer to question 1 is yes, whether the Appellant is trading in derivatives within the meaning of the same regulation.

3. If the answer to question 2 is yes, whether the redemption loss of US$96.3m was derived from the trading in derivatives.

Key observations on the decision by the Board

Question 1: Whether there is a derivative in the Transactions within the meaning of regulation 4(1)(j) of the FSI Regulations

The Respondent's main argument is the Transactions is a hybrid instrument consisting of a host contract in the form of RPS with an embedded derivative in the form of the foreign exchange binary option of JPY/USD. The Respondent further argued that since the payoffs of the embedded derivative were linked to the performance of the JPY/USD index, it falls within the definition of "financial derivatives".

The Appellant position is the term "derivative" under regulation 4(1)(j) should be read narrowly unless there is an express statutory definition under the FSI Regulations, of which there is none. Hence, the Appellant argued that the term "derivative" should not be widen to include embedded derivative.

The Board concluded that there is a derivative in the Transactions in the form of the embedded derivative.

Question 2: Whether the Appellant is trading in derivatives within the meaning of regulation 4(1)(j) of the FSI Regulations

The Appellant submitted that they are not trading in the RPS for the following reasons:

a) The RPS and Transactions were meant to be a short-term financing transaction

b) There is no intention to make a profit through a disposal or redemption of the RPS, i.e. no intention to "trade" in the RPS, as whether the Appellant will make a net gain or loss is beyond the control of the Appellant since it depends on whether or not the Issuer chose to pay a dividend.

c) The RPS were recorded as "non-marketable" securities as the Appellant cannot readily dispose the RPS in the market outside the up-front terms agreed with the Issuer and Bank A.

The Appellant further made the argument that if there was no trading of the RPS, there could not be any trading in the embedded derivative since the embedded derivative cannot be independently traded from its host contract, i.e. RPS.

The Respondent's main argument is the Appellant is in the business of banking and the trading of shares and financial instruments was part and parcel of its business. Applying this broad-based approach, the Respondent went on to argue that the Transactions fulfilled characteristics of the badges of trade.

On this question, the Board adopted a "narrow" rather than the broad brush approach suggested by the Respondent and concluded that the Appellant is **not** "trading in derivatives" based on the following rationale:

i. The embedded derivative does not determine whether the Appellant will make a gain or loss on the RPS. It was the declaration of dividend by the Issuer that would determine whether the Appellant will make a gain or loss.

ii. While the Transactions as a whole would guarantee a net positive return to the Appellant, barring any default by the Issuer, it has the characteristic of a short-term financing transaction. This is supported by the net return of 1.49% to 3.26% range for a financing transaction.

Interestingly, one of the Respondent's witnesses made a comment that had Section 33 (anti-tax avoidance) been invoked, the net gain of US$3.5m from the Transactions would be treated as "interest income" which further supported the financing transaction treatment rather than the "trading" basis.

With the Board's decision above on this question, the Appellant has succeeded in the appeal and rendered the last question irrelevant. However, for completeness, the Board still proceeded to address the next question.

Question 3: Whether the redemption loss of US$96.3m was derived from the trading in derivatives

The Appellant's case is the redemption loss of the RPS was caused by the declaration of dividends and not the embedded derivative. Taken to the extreme, the embedded derivative component would at best contribute a minuscule portion of the redemption loss of US$96.3m

The Respondent took a complete opposite position, stating that the embedded derivative is the main driver or originator of the loss and the full redemption loss of US$96.3m was attributed to the movement of the JPY/USD exchange rate, i.e. the embedded derivative.

The Board did not agree with the Respondent's arguments and particularly took issue with the argument that the embedded derivative is the trigger of the loss and the notion that the entire US$96.3m loss is derived from the "trading in derivatives". The Board further explained that to do so would mean that the main host contract (i.e. RPS) would lose their characters and significance in the Transactions, which in the Board's opinion is "a gap too far to cross".

While the Board disagreed that the entire loss of US$96.3m was derived from "trading in derivatives", it left open the question of whether an appropriate portion should be attributed to the said "trading in derivatives".

Potential implications

While the Appellant has won the appeal, the Board's decision in this case raises several interesting potential implications for financial institutions that have been awarded the Financial Sector Incentive ("FSI").

We will proceed to examine some of these implications.

The use of "trading in" terminology

The terms "trading in", "transacting in" and "investing in" have been used interchangeably in the industry when we determine what falls within the FSI Regulations. One immediate question that comes to mind is would the decision of the Board be different if para 4(1)(j) of FSI Regulations was written as "trading, transacting or investing in derivatives"?

While we do not know the answer to this hypothetical question, most if not all financial institutions that enjoyed FSI have broadly treated gains or losses arising from derivatives as falling within the FSI Regulations without examining in greater details the term "trading in". The Inland Revenue Authority of Singapore (IRAS) seems to have accepted this treatment all these years especially for banks enjoying FSI. This also explains why the Respondent took the broad-based approach in Question 2.

If we are to start using the intention of each derivative trade at the start of the transaction (e.g. trading, hedging, etc) as a litmus test for determining if it falls within the qualifying activity under FSI Regulations, are we opening the door to a host of unforeseen challenges and complications?

In the world of financial markets, it may be difficult to determine if the derivative or the underlying instrument (e.g. debt security) is the hedging instrument or the risk instrument. Even if a bank enters into a derivative with the intention to hedge a risk exposure, could it be viewed as "trading in derivatives" as the intention is clearly to make a profit by liquidating the position to mitigate any loss on the related risk exposure or instrument?

The concept of "embedded derivative"
Some financial products, like structured products, contain embedded derivatives. If these derivatives are not bifurcated and measured separately in the financial statements, the current practice is to treat the gain or loss as wholly attributable to the underlying host contract and the applicable tax rate will depend on the nature of the host contract. Going by the Respondent's argument, does it mean that we can now attribute the entire gain or loss to the embedded derivative and accord it a lower concessionary tax rate if the taxpayer enjoys the FSI – enhanced tier? It is fortunate that the Board disagree with the Respondent's arguments in Question 3. Otherwise, we could end up with an illogical outcome.

Section 33 – Anti-Avoidance Provision
It is interesting to note while one of the Respondent's witnesses made a comment that the Transactions were structured to gain a tax advantage, the Respondent did not invoke his powers under the anti-avoidance provision in Section 3 of the Income Tax Act and decided to proceed on this "trading in derivatives" approach. One cannot help but wonder if the outcome would have been different if Section 33 was invoked.

Conclusion

To conclude, while the door closes on this appeal, depending on the next steps taken by IRAS, some of the potential implications mentioned in the preceding paragraphs could start to materialise.

How we can help

As a committed tax advisor to our clients, we welcome any opportunity to discuss the relevance of the above case to your business.

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