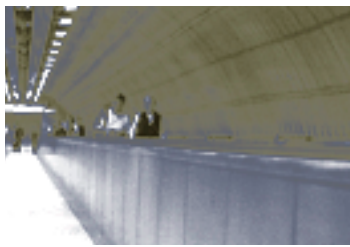


Budget Highlights

3 May 2002



Budget Snapshot:

Corporate income tax changes

- Corporate tax rate reduced to 22% in YA2003 and to 20% in 3 years
- Group relief from YA2003
- One-tier corporate tax system from 1 January 2003 - imputation system scrapped
- "Look-through" provision for foreign tax credits not adopted

Tax incentives changes

- Enhanced and rationalisation of financial services sector incentives
- Rate reduction and packaging of DEI with others
- Enhancement of incentives for shipping and certain R&D activities

Personal income tax changes

- Personal income top marginal tax rate reduced to 22% in YA2003 and to 20% in 3 years
- Personal income tax rates for all income tax bands reduced for YA2003
- "Days-in days-out" basis for new class of "Not Ordinarily Resident" (NOR) taxpayers with effect from YA2003
- Stock options granted for non-Singapore employment will not be taxed
- Stock options granted for Singapore employment will be taxable regardless of where they are exercised
- Enhanced personal reliefs
- No changes to taxation of interest or foreign source income

Other changes

- Payments to international arbitrators exempt from withholding tax with immediate effect
- Final income tax of 15% on the gross income of non-resident professionals with immediate effect
- Estate duty exemption for movable assets of non-domiciles situated in Singapore

Goods and Services Tax changes

- GST rate increased to 5% from 3% with effect from 1 January 2003

Lower corporate tax rates are a good thing, are they not?

Are the proposed changes in relation to stock options useful?

And lower tax for individuals?

So if group relief does not help here, what use is it?

Surely group relief will come to the rescue?

Will any of the changes have an adverse effect, potentially?

Why did the Minister not allow a carry-back of losses?

So will the one-tier system have an effect on corporate group structures?

What are the problems with a "one-tier" system?

Why no exemption of foreign source income and interest for individuals?

So why no exemption for foreign source income earned by companies?

Anything to say about Goods and Services Tax?

Budget Changes – much yet to be done

By The PricewaterhouseCoopers Singapore Budget Commentary Team

On the face of it, the changes announced today by Deputy Prime Minister and Minister for Finance Mr Lee Hsien Loong would appear to herald a simplification of the tax system, and an overall reduction in tax burdens. Reductions in corporate and personal tax rates, the scrapping of the imputation system, and the introduction of a group relief framework all seem to assist in “laying the groundwork for the Singapore economy to grow, prosper and create jobs in a more uncertain and competitive environment”.

This article examines some of the more notable changes announced, and assesses their potential for achieving the stated objectives. It also highlights areas where some serious thinking needs to be done by the draughtsman in moving from design to implementation, as well as areas where clients may need to take a re-look at their legal and financing structures to avoid some potentially unpleasant consequences.

“The general concept of what has been proposed can only be good for the economy,” says Peter Tan, Director of PricewaterhouseCoopers Services Pte Ltd, Tax Advisory Services, “and we can safely say that a good start has been made in the overall design. However, it is clear there is still plenty of work to be done in relation to the drafting of the legislation, which will be a complex task. These changes are wide reaching, and they all interact. But not only do they interact with each other, they also have a significant impact on existing parts of the legislation that may need to be changed as a result.”

It is understandable that the detail, which will drive the changes forward, has not been put together yet, since the Economic think-tank which laid the foundations for the Budget proposals was only formed in December last year. However, in many ways the real thinking is just beginning, as will be seen as we take a look now at some of the major components of the proposed changes, and ask some probing questions.

Lower corporate tax rates are a good thing, are they not?

Lower statutory tax rates should not be confused with lower effective tax rates, which are the measure of the real tax burden, and it is quite possible for statutory rates to be comparatively low, but the effective rate to remain quite high, or even increase as a result of other changes in the legislation, or as a result of the legislation in investor countries.

The issue for companies in the global context is the anti-tax haven, or controlled foreign companies (CFC) legislation imposed by many of our developed trading partners, most notably the United States (US), Australia, Japan and the United Kingdom (UK). The principal aim of CFC legislation is to identify countries which impose unacceptably low rates of tax and to tax the income of subsidiaries operating in them as it arises, rather than wait until the income is repatriated by way of dividend, possibly many years later.

The inference is that home country tax is being artificially deferred or diverted to low-tax jurisdictions. Reduction of tax rates in the investee country, could thus mean that profits which, under a slightly higher tax regime were sheltered from home country tax, now get taxed contemporaneously at the (even higher) home country rates. The reduction in rates has thus resulted in an acceleration of tax, not an additional advantage.

“Generally speaking, however,” says Doug Morgan, Director of PricewaterhouseCoopers Services Pte Ltd, International Tax Team, “attribution will only occur where the subsidiary either enters into specified “bad” transactions, or is merely a paper entity which does not carry on any substantial business activity in that country. Companies carrying on bona fide business operations should therefore generally be unaffected by the reduction in Singapore’s rates, except that there may be some additional reporting requirements to deal with.”

It is also true to say that low tax rates will appeal differently to different investors, depending on the sector they operate in, or on their country of origin. A manufacturer, for example may be more affected by labour costs and the availability of the requisite skills; and a business from a country that allows foreign tax credits may see low foreign taxes as conferring a timing, rather than permanent advantage. However, in the absence of CFC difficulties, it is hard to see how a corporate tax reduction could be harmful.

And lower tax for individuals?

The objective of the proposed reduction in personal tax rates is to attract foreign talent, to allow entrepreneurs to flourish and to reward hard work. At an international level, a low tax rate may be of interest only to those foreigners who can prevent themselves from remaining resident and thus taxable in their country of origin; and for a large number of US expatriates, who remain in the grip of the US Internal Revenue Service wherever they go, the tax rate here can often be largely irrelevant. The new rates will thus have

more appeal to potential long-term permanent residents, and will assist in encouraging them to make a commitment to Singapore.

Domestically, a lower personal tax burden allows taxpayers greater choice, without necessarily a corresponding cost to the Government, assuming that the tax cut translates into consumer spending. By spending, they pay Goods and Services Tax (GST). Alternatively, they can save and help reduce the social burden going forward.

However, if Hong Kong is the benchmark for appealing tax rates, the reduction of the top rate of personal tax to 22 per cent for year of assessment 2003 has not made a significant move towards it, as will be seen from Table 1. In Singapore, the effective 15 per cent rate is crossed at \$360,000, whereas in Hong Kong is \$674,000.

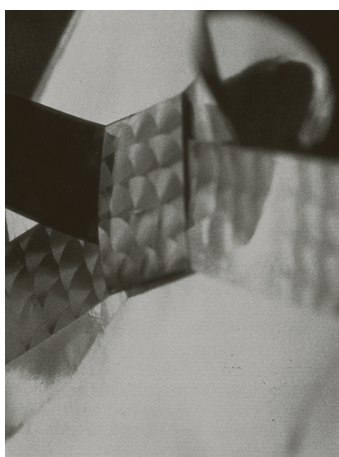


Table 1

<i>Income</i>	<i>Singapore Effective Tax Rate</i>		<i>Hong Kong Effective Tax Rate</i>	
	<i>YA 2002</i>	<i>YA 2003</i>		
<i>\$</i>	<i>%</i>	<i>%</i>	<i>%</i>	
100,000	7.11	6.40	3.49	
200,000	12.11	11.34	10.24	
300,000	15.20	13.89	12.50	
359,400	16.26	15.00	13.24	Singapore hits 15%
500,000	18.09	16.97	14.30	
600,000	18.98	17.81	14.75	
674,000	19.46	18.27	15.00	Hong Kong hits 15%
800,000	20.08	18.86	15.00	
900,000	20.45	19.20	15.00	
1,000,000	20.75	19.48	15.00	

The table shows the effective tax rate of a married expatriate with two children

Are the proposed changes in relation to stock options useful?

What is missing from the Minister's proposals is the recommendation by the Economic Review Committee's Sub-Committee on Taxation (Sub-Committee) to extend the period within which the tax on option gains is payable, from five to seven years, and to dispense with the interest charge on the deferral. This would have been a welcome change, but has apparently not been adopted.

The important change announced in relation to stock options is in relation to gains made on the exercise of options granted under an overseas scheme at a time when the employee was not employed in Singapore. Such gains will not be taxed. Currently, the Inland Revenue Authority of Singapore (IRAS) takes the somewhat unconventional view that the full amount of the option gains are taxable in Singapore if the options are exercised while the employee is working here, even in a situation where he has been here for only a matter of days before exercising the options. This is to be changed so that only gains in respect of Singapore employment will be taxed. It is not clear that this has done much to iron out the existing anomalies. In addition, where options in respect of a Singapore employment are exercised after the employee has left Singapore, the employer is responsible for tracking him and recovering the tax. This raises interesting questions of administration and control.

Will any of the changes have an adverse effect, potentially?

Generally, the tax rates reduction and changes to the taxation of stock options are good news, when taken in isolation. What may be of less appeal in a personal tax context however is the proposed scrapping of the imputation system and its replacement with a one-tier system.

What are the problems with a “one-tier” system?

Under the current imputation system, tax is paid on the profits of Singapore companies at the shareholder's marginal rate of tax; with corporate tax being no more than a prepayment of the shareholder's liability. A reduction in personal rates alone would therefore mean that individual shareholders are better off.

However, the replacement of this two-tier system with one-tier, as is proposed, means that corporate profits remain taxed at the corporate rate, since dividends are exempt from further tax and carry no credits. This has implications for the small businessmen who may have incorporated for liability limitation purposes; it will also affect individual investors in the stock market who had been enjoying tax credits on their dividends; and retirees who may depend on such income could be particularly hard hit.

Seen in this context, it is almost certain that the one-tier system is revenue positive for the IRAS, which is not in keeping with the general intention of reducing taxes. As an indication of the amounts involved, the IRAS annual report 2000, showed that dividend income assessed on individual taxpayers amounted to \$1,520 million for the year of assessment 2000. Even accepting that a portion of this amount may be non-Singapore dividend income and carry no imputation credits, a one-tier system still translates into substantial tax savings for the Government.

So will the one-tier system have an effect on corporate group structures?

“The answer to this question,” explains David Sandison, a Tax Director in the Mergers and Acquisitions Team, “is that the removal of an imputation system may very well have an impact on group structures, particularly if we are talking about groups with highly geared holding companies, or special purpose vehicles (SPV) used in typical property securitisation arrangements.”

Under a typical structure, a holding company or SPV may have borrowed to acquire shares in a Singapore-based subsidiary. There will be interest costs associated with the borrowing, but under the current system, relief will be obtained for these costs by set-off against dividends from the subsidiary. This will result in a repayment of the tax credit attaching to the dividend. The net result of this is that tax paid by the subsidiary is repaid to the holding company to the extent of the interest set-off.

Under the new system, dividends will be exempt from tax. There is therefore nothing to set the interest expense off against and thus no repayment. The effect is that the cost of borrowing for these companies has increased by up to 25 per cent.

Surely group relief will come to the rescue?

It is unclear whether, in the situation described, the group relief provisions would apply to enable the interest expense to be surrendered to the operating entity. This is because group relief may be available only for trading expenses or losses, and the IRAS' view is that holding companies and the like are not carrying on a trade. Until details are released, it will not be possible to comment further. What is clear however is that if relief is not available, certain existing structures will become very expensive to maintain; and every group in Singapore with borrowings or which intends to borrow to make corporate acquisitions, will need to stop and perform a thorough review on the structures they have or intend to have.

So if group relief does not help here, what use is it?

Group relief is a means of setting off the profits of one company in a group, against the losses in another. It essentially recognises the substance of common ownership, over its form, and its main advantage is that it neutralises the tax effect of different legal structures which may be in place for valid commercial considerations. There is no reason, for example, why a company that can organise itself into divisions should pay less tax than a business that has to split itself up into separate legal entities for legal or regulatory reasons.

"It is difficult to fault a group relief system," suggests David, "as it provides choice within equity. There are undoubtedly complications within a Singapore context - particularly where incentives are involved - and it may not be the answer to everybody's prayers, but it is clear that a group relief system of whatever shape or size, is better than no group relief system at all."

One interesting feature of the system is that two Singapore "sister" companies will require a Singapore holding company before the relief will be available.

Why did the Minister not allow a carry-back of losses?

The answer to this question may be that, in absolute terms, a carry-back allows recovery of taxes paid in an earlier year. From a cashflow perspective however, the answer may be markedly different. If the carry-back is compulsory - which in the UK, for example, it is - then it may take many years to obtain a refund if you need to wait until the tax computations of the affected years are agreed. On the other hand, a loss carry-forward allows you to reduce estimates of chargeable income for the next year and thus reduce the tax payable on the very next assessment that comes in. So unless the relief is either optional or provisional repayments can be given, then such a system could have been significantly cashflow positive for the IRAS, thus of no benefit to businesses generally.

Why no exemption of foreign source income and interest for individuals?

There is no doubt that removal of interest from the tax net, as well as exemption for foreign source income for individuals would have enhanced liquidity in the financial markets in Singapore. It is not clear however, how these changes would have affected the direction of savings. Taken in conjunction with the removal of the imputation system (and thus access to tax credits), it may be expected that more attention would have been given by investors to lower-risk interest-bearing products. It may also have had a serious impact on life insurance funds. Currently, income of a life fund attributable to policyholders is taxed in the fund at 10 per cent. With the removal from tax for individuals of all but rental income, investment-linked products would have had some of the shine taken off them had the proposed changes been brought in.

So why no exemption for foreign source income earned by companies?

The reason for not recommending an exemption from tax for foreign source income earned by companies given by the Sub-Committee, was fear of "round-tripping". Under such arrangements, tax deductible payments would be made out of Singapore to a foreign affiliate, and then brought back in tax-free. What is left open to conjecture however, is whether there is a need to remit, and therefore tax, foreign source income in the first place. Removal of the imputation system seems to leave companies open to be able to repatriate profits simply by declaring dividends out of this income, and bypassing Singapore altogether. This would appear to make certain changes relating to the flexibility of the foreign tax credit system unnecessary, and cut across the stated aim of leaving such income in the tax net. It will be interesting to see how the matter is addressed.

Anything to say about Goods and Services Tax?

GST should not generally be a cost to businesses, except where they get it wrong or are partially exempt. The costs of GST errors therefore increase commensurately with the increase in rates; and obviously there will be an incremental cost to partially exempt businesses, most notably the banks.

There is also a need to ensure that the transition to the higher rate is handled properly, as those around in 1994 when the system was first introduced will remember. Issues such as wording of contracts, time of supply and the like will all need to be considered carefully, and proper instructions given to staff handling GST matters. Also those companies intending to "swallow" the increment need to ensure they get documentation, calculations and paperwork right.

For more in-depth technical review of the Budget changes, visit our website at <http://www.pwctax.com>

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